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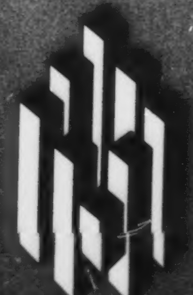
OTTAWA'S NEXT AGENDA

Policy Review and Outlook, 1989



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Foreword

As Canadians approach the final decade of the twentieth century, they are becoming increasingly aware of the challenges they face within the global system. Economic, technological, sociodemographic, and environmental changes today transcend national boundaries and determine each country's performance in the new global economy. Inward-looking policy strategies cannot succeed in such a world without imposing significant costs on countries that pursue them.

For this reason, recent developments in Canadian economic policy — characterized by a shift toward a more outward-looking and market-oriented posture — are an encouraging sign that Canada is preparing to meet the challenges of the 1990s.

Policy Review and Outlook, 1989 was written in the autumn of 1988, during a federal election campaign that focused on the contentious issue of Canada-U.S. free trade. Other issues are also of concern, however, and it is in this light that the study examines the evolution of the Progressive Conservative government's policy agenda over the 1984–88 period.

The government's progress in implementing its agenda has been mixed. In some areas — trade policy, regulation, and income tax reform — it made significant progress. In other areas — deficit reduction, privatization, and science and technology policy — it began to move in the right direction, but much more needs to be done. In still other areas — unemployment insurance reform, federal sales tax reform, and reform of income security programs — the government made virtually no progress.

Returned to power with another majority, the federal government should now focus its next agenda on a two-pronged strategy of restoring fiscal balance within government and removing obstacles to economic growth in the private sector. To succeed, however, the government will have to do a better job of convincing Canadians of the benefits of this strategy. It will also have to give higher priority to improving social policies and preserving the environment.

Ted Carmichael, Vice-President and Director of Policy Research, directed the preparation of the *Policy Review and Outlook*. This year, he was joined by two co-authors: Katie Macmillan, Policy Analyst, who was responsible for the analysis of agriculture and social policies, and Robert C. York, Policy Analyst, who was responsible for the analysis of regulatory, competition, and trade policies. William B.P. Robson, Policy Analyst, assisted with the analysis of Canadian economic performance in Chapter 1. The manuscript was ably edited by Barry A. Norris and expertly typed by Brenda Palmer.

The conclusions and recommendations presented here are based on the Institute's active research and publications program over the past several years, as well as on new research. The authors have benefited from discussions with their colleagues at the Institute and a wide range of outside experts, including the Chairman and members of the C.D. Howe Institute Policy Analysis Committee. As always, the conclusions are the responsibility of the Institute's staff; they do not necessarily represent the views of the Institute's members or directors.

Maureen Farrow
President
January 1989

PART I

Looking Back

1

Prologue to the 1990s

The start of each year is an occasion to look back and to look ahead, to use the lessons of the past to shape future goals. In 1989, there is particular reason to undertake this exercise. Canada has just come through a tough and emotional election campaign that focused predominantly on the issue of free trade with the United States. Following a debate that ran the gamut from reasoned argument to shameless scaremongering, Canadian voters decided to take the "leap of faith" that Donald Macdonald, among others, had recommended in 1985.

The free trade debate was revealing, not so much about the contents of the Canada-U.S. Agreement, but about what Canadians believe the nature of their country to be. It revealed that Canadians prefer an outward-looking approach to economic policy — to continue Canada's 50-year quest to reduce trade barriers and to improve access to larger markets. It also revealed that Canadians are staunch defenders of their national identity, culture, and environment, and the interpersonal and interregional sharing embodied in Canada's social and economic policies.

In this sense, one can interpret the outcome of the election as a victory for both advocates and opponents of free trade. Its advocates are pleased that the deal will be implemented and secure access to the U.S. market that the deal provides. At the same time, opponents sent a clear message to the new government: the trade deal must not put at risk those things that set us apart as Canadians.

The historic decision on free trade is not the only event on which Canadians have cause to reflect. In re-electing the Progressive Conservative government, Canadians renewed its mandate to pursue the new directions in economic policy it began in 1984. Changes in other policy areas, such as regulation, privatization, deficit reduction, and tax reform — though less controversial than free trade — are elements of a major shift in Canadian economic policy. This shift ultimately may prove as significant as the trade deal, if not more so, as Canada enters the 1990s.

The next decade is likely to see a continuation of the volatility in world markets that has been so evident in the 1980s. Major forces of change are at work, not only in the economy but in the world's technology, demography, and environment. Countries that adopt policies aimed at ensuring their international competitiveness, fiscal flexibility, and general adaptability will be best able to cope with change and take advantage of the opportunities that the 1990s will bring. Canada needs to prepare itself to meet these challenges.

Thus, the theme of *Policy Review and Outlook, 1989* is "Ottawa's Next Agenda". Its focus is on the economic priorities that Canada faces as it approaches the 1990s. Part I of this study looks back, by examining the recent performance and current state of the Canadian economy and by assessing the federal government's policy record over the 1984–88 period. Part II looks ahead. It begins by examining the main forces of change in the global economy, which all countries, including Canada, must anticipate and respond to in the years ahead. The final chapter is devoted to a detailed assessment of the next policy agenda facing the new federal government.

Canada's Recent Economic Performance in Perspective

The past four years marked a new direction for economic policy in Canada. The change of approach was first laid out in Finance Minister Michael Wilson's Economic Statement of November 1984.[1] The agenda evolved in subsequent policy statements, but the framework remained reasonably faithful to the original statement.

The evidence suggests that the performance of the Canadian economy has improved with the change in policy direction. This judgment is based on both historical and international comparisons. An historical comparison of how the economy has performed over the past four years relative to earlier periods must take account of cyclical factors and important changes in world markets that directly affect Canada. International comparisons, to be valid, need to consider not only Canada's performance relative to other countries, but also how this relative performance has changed over time.

Figures 1 through 5 compare Canada's recent performance, measured by several key economic indicators, with that of the United States and the average of all members of the Organisation for Economic Co-operation and Development (OECD).[2] Table 1 summarizes this record and compares Canada's performance with that of the United States and the OECD over the 1976–84 and 1984–88 periods. The latter period coincides with the Conservative government's first term, while the former period spans one full economic cycle beginning with the expansion of 1976–81 and including the 1981–82 recession and the 1983–84 recovery.

These figures and the table show that, according to the key

---

[1] Hon. Michael H. Wilson, *A New Direction for Canada: An Agenda for Economic Renewal* (Ottawa: Department of Finance, November 1984).

[2] For a similar assessment of Canada's recent economic performance, see Organisation for Economic Co-operation and Development, *Canada* (Paris, 1988).

Table 1
Summary of Key Economic Indicators for Canada, the United States, and the OECD, 1976–88[a]

	Canada		OECD Average		United States		Ratio: Canada to OECD		Ratio: Canada to U.S.	
	1976–84	1984–88	1976–84	1984–88	1976–84	1984–88	1976–84	1984–88	1976–84	1984–88
Real Gross Domestic Product	2.9%	3.9%	2.6%	3.0%	2.7%	3.1%	1.13	1.32	1.07	1.26
Real business fixed investment	4.0	9.0	3.7	5.6	4.9	3.5	1.08	1.62	0.82	2.59
Employment	1.9	3.0	0.9	1.4	2.1	2.2	2.04	2.20	0.89	1.37
Productivity	1.0	0.9	1.7	1.6	0.6	1.1	0.59	0.56	1.66	0.82
Unemployment rate (%)[b]	9.1	9.1	6.9	8.0	7.6	6.5	1.32	1.14	1.21	1.41
Consumer prices	8.7	4.1	8.5	3.4	7.8	3.3	1.02	1.20	1.11	1.26
Government fiscal balance (% of GDP)[b]	-3.9	-5.1	-2.9	-2.9	-1.3	-2.9	1.33	1.73	3.03	1.76

[a] Compound annual average rates of increase, unless otherwise indicated.

[b] For these indicators, all comparisons are 1977–84 versus 1985–88.

Source: C.D. Howe Institute, based on data from Statistics Canada, U.S. Department of Commerce, and the Organisation for Economic Co-operation and Development.

measures of economic activity, Canada has performed better over the past four years than it did over the previous eight. Annual growth of real Gross Domestic Product (GDP) was higher by one percentage point, business investment growth was higher by five percentage points, employment growth was up 1.1 percentage points (equivalent to more than 100,000 jobs) annually, and consumer price inflation was down by 4.6 percentage points per year.

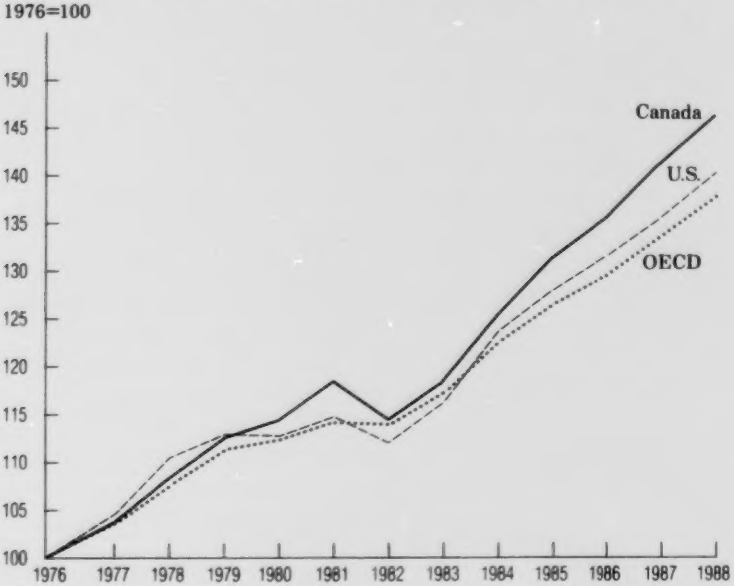
In part, these substantial improvements reflect cyclical factors. The 1984–88 period was one of unbroken expansion, whereas the 1976–84 period contained a serious worldwide recession that hit Canada particularly severely. Growth of GDP, capital investment, and employment have been stronger in the OECD generally during the past four years, and inflation has been subdued relative to the experience of the 1976–84 period.

Economic Growth and Employment Performance

Although Canada has benefited from a favorable external environment over the past four years, its economic performance has improved relative to both the United States and the OECD average by most measures since 1984. Canada's improved performance, therefore, cannot be attributed solely to outside factors. The favorable margin between rates of GDP growth in Canada and the rest of the OECD has widened, with business investment showing a particularly marked improvement.

Figure 1 illustrates the comparatively steep drop in economic activity in Canada in 1982, as well as the initially slower recovery than in other OECD countries, followed by a consistently stronger pace of expansion since 1983. Between 1976 and 1988, Canada's GDP rose by 42 percent, compared with about 34 percent for the United States and the OECD average; about two-thirds of this gap has emerged since 1984.

Figure 1
Real Gross Domestic Product in Canada, the United States, and All OECD Countries, 1976–88[a]



[a] Data for 1988 are estimates by the Organisation for Economic Co-operation and Development. U.S. data refer to Gross National Product.

Source: C.D. Howe Institute, based on data from the Organisation for Economic Co-operation and Development.

Figure 2 shows that, since 1984, Canada's job creation record has been unsurpassed. This phenomenon is reflected in the closing gap between the Canadian and OECD unemployment rates, shown in Figure 3, despite the much faster growth of Canada's labor force. Canada's labor market is characterized by a high degree of turnover, and Canadian workers demonstrate significant flexibility in moving or changing occupations to find a job.

This turnover may have had a cost in terms of the growth of labor productivity — GDP per employed person has in-

Figure 2
Employment in Canada, the United States, and All OECD Countries, 1976–88[a]

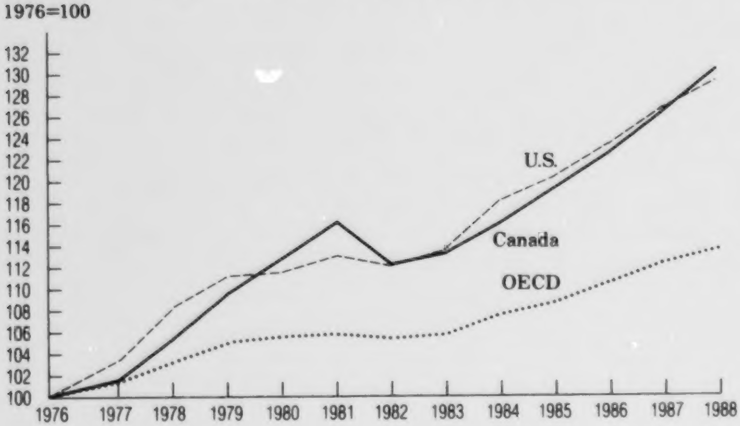
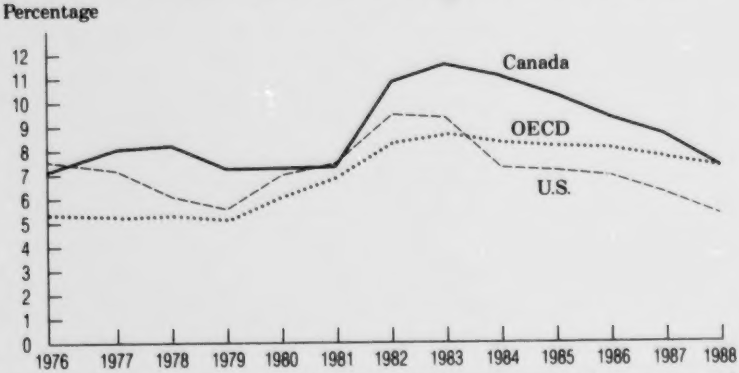


Figure 3
Unemployment Rates in Canada, the United States, and All OECD Countries, 1976–88[a]



[a] Data for 1988 are estimates by the Organisation for Economic Co-operation and Development.

Source: C.D. Howe Institute, based on data from the Organisation for Economic Co-operation and Development.

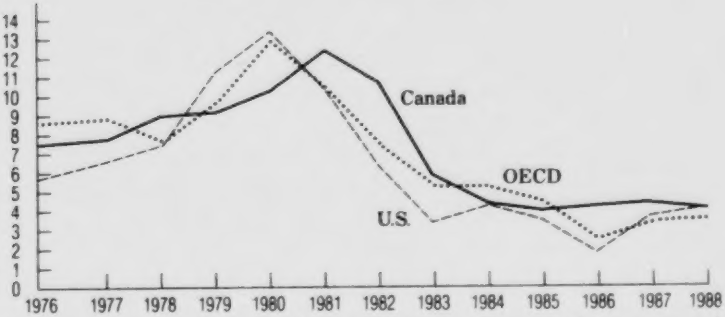
creased by only about 0.9 percent annually in Canada since 1984, lower than the OECD average of 1.6 percent — since it means that productivity gains that come from years of training and experience are lower in Canada than in other industrial countries. This is more than made up for, however, by the impressive gains in the number of people employed that flexibility permits. It also means that Canadian living standards have improved in the 1980s not because of strong productivity gains but because of much increased employment of the working-age population. Indeed, in 1988, the employed proportion of Canada's population over 15 years old stood at 61.5 percent, its highest level ever.

Measures of comparative inflation rates and government budget deficits show Canada in a less favorable light. The increase in Canada's Consumer Price Index (CPI) has slowed by less than comparable measures for the United States and the rest of the OECD, as shown in Figure 4. Prices for several of Canada's major commodity exports have been unusually weak over the course of the current economic expansion. Yet Canada's inflation rate remains above that of the other large industrial countries. Since 1984, consumer prices have risen at a 4.1 percent annual rate in Canada, compared with a 3.2 percent rate in the United States, and just under 1 percent in West Germany and Japan.

The fiscal position of the Canadian public sector compares poorly with that of the OECD as a whole, as shown in Figure 5. (The deterioration of the U.S. public sector's fiscal position has been more dramatic, but as a proportion of national income the U.S. general government deficit remains well below that of Canada.)

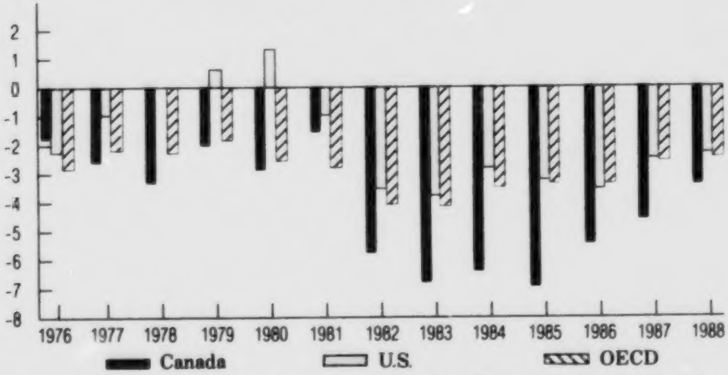
One might speculate that Canada's failure to deal more aggressively with its budget deficit during the past four years of strong economic growth has contributed to its poorer inflation performance compared with other OECD countries. As the Canadian economy grew rapidly in 1987 and 1988 and increasing utilization of industrial capacity started to produce

Figure 4
Consumer Price Inflation in Canada, the United States, and All OECD Countries, 1976–88[a]
(annual percentage change)



[a] Data for 1988 are estimates by the Organisation for Economic Co-operation and Development and the C.D. Howe Institute.

Figure 5
General Government Budget Balances in Canada, the United States, and All OECD Countries, 1976–88[a]
(as a percentage of GDP/GNP)



[a] Data for 1988 are estimates by the Organisation for Economic Co-operation and Development.

Source: C.D. Howe Institute, based on data from the Organisation for Economic Co-operation and Development.

inflationary pressures, diminishing fiscal restraint pushed the task of containing inflation increasingly onto the Bank of Canada. Since mid-1987, it has taken increasingly forceful steps to dampen inflation.[3]

The Bank of Canada cannot effectively maintain economic growth and price stability, however, without the support of an appropriate fiscal policy.[4] If government budget deficits are not reduced significantly in the near future, Canadians can expect further inflationary pressures. This will leave the Bank little choice but to allow short-term interest rates to rise, thereby dampening growth in interest-sensitive sectors of the economy such as housing and consumer durables.

Canada's economic performance clearly improved over the 1984–88 period. It regained its position among the leaders in growth of national income and employment that it lost in the late 1970s and early 1980s. Part of this improvement is attributable to the stronger growth of the world economy. The international environment, however, is not responsible for the substantial improvement in Canada's relative economic performance. In this respect, one must give credit to the federal government's economic policies, which created an improved climate for growth. This is not to say that these policies have been entirely satisfactory — Canada's performance on inflation and the government deficit remain inferior to most other OECD countries. And if Canada is to maintain its improved real growth performance, it will have to contain inflation and lower its government deficit, the two main sources of vulnerability.

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[3] Peter Howitt, "Monetary Policy in the Medium Term: The Prospects for Monetary Stability in Canada" (Paper presented to the John Deutsch Roundtable, Queen's University, Kingston, Ont., April 26, 1988).

[4] See John W. Crow, "The Work of Canadian Monetary Policy" (Eric J. Hanson Memorial Lecture, University of Alberta, Calgary, January 18, 1988. Reprinted in *Bank of Canada Review*, February 1988, pp. 3–17).

The World Economy: No Time for Complacency

As Canadians look ahead to the new government's economic agenda, prospects for a continuation of the current economic expansion are a central concern. The risks facing the expansion — just beginning its seventh year, it is Canada's second longest in the postwar era — emanate not only from domestic sources but also from the world economy. Since 1985, international economists have worried about the possibility of a global "hard landing". These worries remain, even though the world economy and financial system appear to have weathered the worldwide stock market crash of October 1987.[5] Indeed, 1988 contained some surprising developments.

At the beginning of the year, the outlook for the world economy was gloomy. Actual economic performance, however, was much stronger than expected in the industrial countries. Real GDP expanded by about 4 percent, compared with earlier forecasts of under 3 percent, as shown in Table 2. The impact of the stock market crash appears to have been minimal, and the major economies — particularly the United States, Canada, the United Kingdom, Japan, and West Germany — showed a remarkable ability to sustain above-potential rates of growth. There were early fears that the stock market crash would slow investment spending by raising the cost of equity capital, but business investment expanded strongly in most industrial countries in 1988.

Another surprise was the apparent speed with which current account imbalances improved among the industrial countries. After rising to an annual rate of U.S.$168 billion in

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[5] See, for example, Stephen Marris, *Deficits and the Dollar: The World Economy at Risk,* Policy Analyses in International Economics 14 (Washington, D.C.: Institute for International Economics, 1985); and Richard G. Lipsey and Murray G. Smith, *Global Imbalances and U.S. Policy Responses: A Canadian Perspective,* CAC 55 (Toronto; Washington, D.C.: Canadian-American Committee, 1987).

Table 2
Growth of the World Economy, 1987–88

	1987 Actual	April 1988 Estimate	September 1988 Estimate
All countries	*3.2%*	*3.0%*	*3.8%*
Industrial countries	*3.3*	*2.8*	*3.9*
United States	3.4	2.9	4.0
Japan	4.2	4.1	5.8
West Germany	1.8	1.7	2.9
France	2.2	1.6	2.9
United Kingdom	4.4	3.0	4.0
Italy	3.1	2.5	3.0
Canada	4.0	3.4	4.2
Other industrial countries	2.8	1.9	2.6
Developing countries	*3.4*	*3.7*	*3.6*
Africa	2.2	3.1	2.6
Asia	6.8	6.9	7.3
Europe	2.5	2.1	2.6
Middle East	-0.5	1.5	0.9
Latin America	2.5	2.1	1.4
Other countries	*2.6*	*3.4*	*3.4*

Source: International Monetary Fund, *World Economic Outlook* (Washington, D.C.: October 1988), pp. 23, 64.

the third quarter of 1987 and contributing to the turbulence in financial markets, the U.S. current account deficit fell to a U.S.$135 billion annual rate in the second quarter of 1988. At the same time, Japan's current account surplus dropped to U.S.$67 billion from U.S.$80 billion. U.S. exports boomed in 1988; so, too, did Japanese imports. These trends, combined with the resolution of a long-standing U.S.-Japanese trade dispute on citrus and beef products, helped to reduce tensions between the two countries that their large trade imbalances had exacerbated. Nevertheless, progress in reducing imbalances among the industrial countries continues to be difficult, and protectionist pressures remain.

A third surprise in 1988 was the move by the industrial countries to capacity utilization rates not seen since 1973–74. While the high operating rates have spurred a desirable increase in capital spending, it is unclear whether new capacity will come into use quickly enough to help dampen the buildup of inflationary pressures. If it does not, the risk of the industrial countries' economies overheating will become more serious.

While the industrial economies grew faster than expected in 1988, economic performance in the developing countries was mixed. In Asia, growth was stronger than expected, particularly in China, India, and the newly industrializing countries (NICs). In Africa and Latin America, however, economic activity was relatively stagnant as inflation accelerated and debt problems worsened.

Causes for Concern Remain

In spite of the unexpectedly good performance of the world economy in 1988, the problems that contributed to the stock market crash have not been resolved. There have been some encouraging improvements, but the trade and fiscal imbalances that have plagued the global economy throughout much of the current expansion remain.

The improvement in the U.S. trade and current account deficits could be short lived. The U.S. dollar appreciated relative to other world currencies through much of 1988. In the short term, the rising dollar contributed to the reduction of the U.S. trade deficit by reducing the U.S. dollar price, and therefore the value, of U.S.imports. By year-end, however, the dollar had again depreciated, reversing the temporary positive effect on the trade deficit. More fundamentally, the main obstacles to reducing the U.S. trade deficit — the continuing strong growth of U.S. domestic demand and the large gap between domestic saving and investment — have yet to be addressed through firm action to reduce further the U.S. budget deficit. Failing such action, the recent decline in the U.S. current account deficit could again be reversed.

Another risk is that the U.S. economy will run into capacity constraints, which will cause the recent upward creep in U.S. inflation to accelerate. Without action to cut the U.S. budget deficit, monetary tightening would be the only policy instrument available to contain inflationary pressures. This course of action would help calm concerns about inflation, but it would also boost short-term interest rates.

A rise in interest rates associated with a tightening of monetary policy would not be an unusual way to stall the current lengthy economic expansion. What is unusual, however, is the high level of indebtedness in the world economy, which makes a significant increase in interest rates risky.

Within the U.S. economy, the corporate sector is highly leveraged after years of debt-financed takeovers and junk bond issues.[6] At the same time, many U.S. financial institutions, including savings and loans institutions and some regional banks, are in severe financial difficulty. Also vulnerable to higher interest rates are some of the highly indebted developing countries in Africa and Latin America.

One cannot be complacent, therefore, about the economic performance of 1988. The world economy remains vulnerable to an inflationary outburst or an economic policy mistake. On the positive side, the stock market crash of 1987, by cooling the tensions in financial markets, bought some time for the industrial economies to deal with the root causes of their vulnerability. Nevertheless, more needs to be done. Large government budget deficits need to be reduced, not only in the United States but also in countries such as Canada and Italy. Domestic demand needs to be dampened in countries facing trade deficits and inflationary pressures (the United States, the United Kingdom, and Canada). More reliance needs to be placed on domestic demand growth in countries with trade surpluses (Japan, West Germany, and the Asian NICs). Expanded world trade needs to be promoted, particularly exports from the heavily indebted developing countries. This agenda for sensible economic policies that serve not only the global interest but also the self-interest of the major industrial countries is not new. But this lack of novelty makes the agenda no less relevant or urgent in solving the problems facing the global economy.

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[6] A recent study found that if the U.S. economy went into recession with interest rates moving as they did in 1973–74, 10 percent of U.S. firms could go bankrupt. See Ben S. Bernanke and John Y. Campbell, "Is There a Corporate Debt Crisis?" *Brookings Papers on Economic Activity* (1:1988): 83–139.

A country such as Canada, heavily dependent on trade and, therefore, on a healthy world economy, can make a small but important contribution to global economic stability by adopting sound policies at home. These same policies can help reduce — although they can never eliminate — Canada's vulnerability to negative shocks in the world economy. It is impossible to say in early 1989 whether the needed adjustments in the world economy will take place quickly enough to avoid a serious recession. What is clear, however, is that countries that move to correct their own fiscal and trade imbalances will be in better shape to deal with turbulence in the world economy of the 1990s than those that do not.

2

The 1984 Agenda

In September 1984, Canadians, voting overwhelmingly for change, gave the Progressive Conservative party the largest parliamentary majority in Canadian history. The election campaign did not focus on solutions to specific problems, however, and the electorate did not send the new government a precise message on exactly what direction changes in public policy should take.

There was a consensus, however, that the Canadian economy had performed poorly over the previous decade. To many Canadians, the federal budget deficit — which had ballooned to over $30 billion — and the accumulated national debt symbolized poor economic management. Over 70 percent of Canadians, according to one poll, thought that there was too much government interference in their lives.[1] These concerns were real enough, but it remained for the new government to lay out a detailed blueprint for change.

This chapter examines how the federal government's economic policy agenda evolved from 1984 to 1988, the progress made in implementing the agenda, and some policy areas that did not receive attention during this period.

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[1] Anthony Westell and Alan Frizzell, *The Canadian General Election of 1984* (Ottawa: Carleton Press, 1985), p. 103.

In some areas of economic policy, the new government had clear ideas of the type of change that it wanted to enact from the outset. In other areas, its approach evolved gradually, reflecting the results of internal assessments, advice from expert bodies — most notably the Macdonald Commission — and reactions to external developments, particularly the rise of U.S. protectionism and the successful U.S. tax reform of 1986.

The Evolution of the Policy Agenda, 1984–88

Since the Conservative government was elected with a mandate for change but was given no clear direction on specific policies, it needed a blueprint. Finance Minister Michael Wilson delivered one on November 8, 1984, with the tabling of *A New Direction for Canada: An Agenda for Economic Renewal* — referred to here as the *1984 Agenda*.[2]

The economic policy strategy contained in this document was only partially formulated. Pulled together in just two months, it collected promises made during the election campaign and an assessment of the government's fiscal situation prepared by the Department of Finance. Its theme was that if Canada's economic performance was to improve, the federal government would have to take the lead in two areas. First, it would have to put its fiscal house in order by reducing the budget deficit and limiting the accumulation of public debt. Second, it would have to redefine the role of government by replacing policies that presented obstacles to change and growth with those that fostered investment, innovation, and international competitiveness.

The general tone of the *1984 Agenda* is perhaps best summed up by a quotation that expresses the kind of frank

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[2] Hon. Michael H. Wilson, *A New Direction for Canada: An Agenda for Economic Renewal* (Ottawa: Department of Finance, November 1984).

Table 3
The Federal Government's 1984 Policy Agenda Proposals and Actual Policy Changes

Policy Area	Proposed Policy Change	Actual Policy Change
1. Fiscal Policy	(a) Reduce the deficit.	(a) Deficit reduced to 4.9% of GDP in fiscal year 1988-89 from 8.6% in 1984-85.
	(b) Reduce government spending relative to GDP.	(b) Spending reduced to 22.5% from 24.5% of GDP by fiscal year 1988-89.
	(c) Avoid tax increases.	(c) Taxes increased to 17.6% from 15.9% of GDP by fiscal year 1988-89.
	(d) Stop federal debt from growing faster than the economy.	(d) Growth of debt reduced from 24% to 10%. Still growing faster than the economy.
2. Trade Policy	(a) Work within GATT to improve multilateral trade rules.	(a) Participated actively in Uruguay Round negotiations.
	(b) Examine options for bilateral trade liberalization.	(b) Completed negotiation of comprehensive Canada-U.S. Free Trade Agreement.
3. Regulation	(a) Reform regulation of financial institutions.	(a) Completed first phase relating to regulation of securities industry.
	(b) Reform competition law.	(b) Implemented new *Competition Act.*
	(c) Reform transportation regulation.	(c) Implemented new *National Transportation Act.*
	(d) Review mandate and management of Crown corporations.	(d) Established policy toward privatization.
4. Energy	(a) Move to market pricing for oil.	(a) Completed.
	(b) Encourage flexibility of natural gas pricing.	(b) Completed.

Table 3 - continued
The Federal Government's 1984 Policy Agenda Proposals and Actual Policy Changes

Policy Area	Proposed Policy Change	Actual Policy Change
4. Energy	(c) End Petroleum Incentives Program.	(c) Completed.
	(d) Review federal energy taxation.	(d) Ended federal energy taxes introduced in National Energy Program.
5. Regional Development	(a) Review approach to regional policy.	(a) Introduced Atlantic Opportunities Agency and Western Diversification Program.
6. Labor Market Policy	(a) Review federal training programs.	(a) Implemented new *Training and Employment Act.*
	(b) Review UI program.	(b) Completed review. No action.
	(c) Consult on industrial relations.	(c) National public consultations initiated and discontinued.
7. Science and Technology Policy	(a) Rationalize tax and grant system for R&D.	(a) Began to rationalize system. Introduced refundable R&D tax credit for small firms.
	(b) Broaden definition of R&D for tax purposes.	(b) Definition broadened to include immediate writeoff of all current and capital expenditures.
8. Adjustment Policies	(a) Review adjustment programs.	(a) No action.
9. Social Policy	(a) Target social benefits better.	(a) Targeting improved in family benefits area. No significant improvements for elderly benefits.

self-assessment one would only expect to hear from a new government:

> Government has become too big. It intrudes too much into the marketplace and inhibits or distorts the entrepreneurial process. Some industries are over-regulated. Others are over-protected, not just from imports but also from domestic competition. Some programs designed to facilitate investment have the perverse effect of distorting investment decisions. Other programs carry on long after the need for them has passed, and are only a fiscal drain. In many cases, the federal government has not done the job it should have, in support of private sector initiatives. In part its resources have been misdirected, adding to a deficit that constrains the government's flexibility.[3]

While the language of the *1984 Agenda* was bold, its actual policy proposals for implementing change were more modest. Table 3 presents the policy areas in which the *1984 Agenda* proposed changes and the actual policy changes that have taken place. Two general observations are in order.

First, in some policy areas, such as energy and foreign investment, the government made specific proposals. In many other areas, such as trade, regional development, regulation, science and technology, and labor market and adjustment policies, the government made few specific proposals, instead raising questions and promising to review current policies. The government moved quickly in areas where it had done its homework and where there was limited resistance, but preferred to proceed cautiously elsewhere.

Second, two of the government's most important policy thrusts over the 1984–88 period — Canada-U.S. free trade and comprehensive tax reform — were not centerpieces of the *1984 Agenda*. The government did indicate that it would review its trade options, including Canada-U.S. trade liberalization. It also indicated that it would review some business tax incentives, study the value-added tax, and try to simplify the tax system. But it contemplated neither the kind of comprehensive trade agreement that was initialled by negotiators in October 1987 nor the comprehensive tax reform that was introduced in June 1987.

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[3] Ibid., pp. 23–24.

The government has sometimes claimed that the policy agenda it ended up with in 1988 was based on its *1984 Agenda*. There is some truth to this statement. Yet it is also true that key parts of the eventual agenda were developed later in response to new developments. This is not a criticism. On the contrary, the agenda's evolution demonstrated the government's ability to respond to new developments within a consistent framework. Indeed, the virtue of the *1984 Agenda* may be more that it established a framework and a process for policy reform that permitted the government's specific priorities to evolve. Previous federal governments had noticeably lacked such a framework and process.

The Macdonald Commission

The release of the *Report* of the Royal Commission on the Economic Union and Development Prospects for Canada (Macdonald Commission) in April 1985 was a timely one.[4] Its broad themes meshed well with the *1984 Agenda,* and its specific recommendations not only were broadly consistent with the philosophy underlying the *1984 Agenda* but also provided a rich menu of choices for the government.[5] Some of the key recommendations included:

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[4] Royal Commission on the Economic Union and Development Prospects for Canada [Macdonald Commission], *Report* (Ottawa: Supply and Services Canada, 1985).

[5] For a critique and interpretation of the *Report*'s economic policy framework and recommendations, see Edward A. Carmichael, Wendy Dobson, and Richard G. Lipsey, "The Macdonald Report: Signpost or Shopping Basket?" *Canadian Public Policy* 12 (February 1986): 23–39.

- negotiation of a free trade agreement with the United States — this was the centerpiece of the Commission's report and embodied its emphasis on adjustment and increased reliance on market forces;
- a market-oriented industrial policy emphasizing a strengthened role for competition policy, reform of the regulatory framework, a moratorium on increases in public ownership, the easing of foreign investment review procedures, and reduced use of subsidies to prop up declining industries;
- an education and training policy focused on promoting economic adjustment and competitiveness by providing funding directly to students and trainees and by encouraging competition and pursuit of excellence among colleges, universities, and training institutes;
- a regional development policy that would reduce federal responsibility for regional job creation, to focus instead on removing obstacles to growth and competitiveness that exist in some regions;
- a sweeping reform of social policy, with recommendations for reform of unemployment insurance and income security programs and the introduction of a new adjustment assistance program — these proposals represented a logical counterpart to those on trade and industrial policy because they were designed to encourage and facilitate the economic adjustments that greater reliance on market forces would bring about.

Given the sweep of the Macdonald Commission's recommendations, the government embraced only those that fit its own immediate priorities— primarily Canada-U.S. free trade and a more market-oriented industrial policy. The other recommendations, including comprehensive reform of Canadian social policies, remain as innovative and worthy of consideration in 1989 as they were in 1985.

Progress in Achieving Economic Goals

In evaluating the government's progress in achieving its key economic goals, the remainder of this chapter focuses on the following initiatives:

- sustaining economic growth without inflation while reducing the budget deficit and slowing the growth of debt;
- regulatory reform encompassing foreign investment review, energy, transportation, and financial industry regulation;
- revision of Canada's antiquated competition policy;
- a program of privatization of Crown corporations and government operations;
- improving the effectiveness of Canada's science and technology policies;
- pursuing a two-track trade policy aimed at improving Canada's access to the U.S. and other world markets through bilateral and multilateral negotiations;
- reform of the federal income and sales tax systems; and
- reform of unemployment insurance and improved targeting of other social programs.

Fiscal and Monetary Policy

The situation the federal government inherited in 1984 was that of an economy still in the early stages of recovery from the 1981–82 recession. That recession had hit Canada harder than most other industrial countries; its lingering effects included an unemployment rate of 11.6 percent, depressed private investment, a weak currency, a high government budget deficit, and a rapidly growing public debt.

In its *1984 Agenda,* the government set itself three macroeconomic objectives:

- to sustain noninflationary economic growth at a rate sufficient to bring down unemployment;
- to make steady, year-over-year reductions in the federal budget deficit; and
- to reduce the growth of the federal public debt so that it no longer exceeded the growth of the economy — that is, to stabilize the ratio of public debt to GDP — by 1990.

The government noted that large deficits and rapidly rising federal debt posed an obstacle to growth in the private sector in the short term and exposed the economy to unnecessary risks in the longer term.

Taken together, the government's three objectives called for a substantial shift in Canada's macroeconomic policy mix. During the 1981–84 period, the previous government had pursued a policy mix of tough monetary restraint to break the inertia of double-digit inflation and fiscal ease to cushion the impact of the 1981–82 recession. While this approach succeeded in breaking inflation, it created its own problems of unemployment and rapidly escalating debt. By 1984, Canadian economists had reached a consensus that a shift in the policy mix toward fiscal restraint accompanied by monetary accommodation was essential to sustain noninflationary growth.[6]

In the period since 1984, the mix of monetary and fiscal policy has indeed changed, as shown in Table 4. Fiscal policy turned restrictive in 1986, as indicated by the change in the cyclically and inflation-adjusted budget deficit. Measures adopted in November 1984 and in the May 1985 and February 1986 budgets resulted in a shift toward fiscal restraint equivalent to almost two percent of GDP in 1986. The move toward fiscal restraint was accompanied by a more accommodative monetary policy, reflected in an increase in the rate of real monetary expansion and a drop of almost two percentage points in real short-term interest rates.

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[6] See, for example, C.D. Howe Institute and the University of Toronto, Institute for Policy Analysis, "Economists Agree on Federal Deficit's Significance," *Communiqué*, November 13, 1984.

Table 4
Indicators of Fiscal-Monetary Policy Mix, 1984–88

	Fiscal Policy	Monetary Policy	
	Change in cyclically and inflation-adjusted budget balance[a]	Growth rate of real M2[b]	Real interest rate[c]
1984	-0.8	1.3	7.7
1985	-0.5	6.6	5.9
1986	1.4	6.2	5.0
1987	0.4	5.7	4.9
1988	0.7	6.3[d]	5.5[d]
1989 projected	-0.5	n.a.	n.a.

[a] A negative sign indicates a larger deficit — that is, a move toward fiscal expansion.

[b] M2 deflated by GDP deflator.

[c] 90-day corporate paper rate adjusted by personal consumption deflator.

[d] Based on first nine months of 1988.

Sources: Organisation for Economic Co-operation and Development, *OECD Economic Outlook*, June 1988, p. 24; *Bank of Canada Review*, various issues.

The economy continued to grow strongly from late 1984 through early 1986, with the contractionary impact of fiscal policy being more than offset by the more accommodative monetary policy. In early 1986, however, the pace of economic growth was slowed by the sharp drop in the world prices of crude oil and grain, which dealt a severe blow to the economic recovery just getting under way in western Canada.[7] There was an immediate falloff in energy- and agriculture-related employment and investment. The federal and provincial governments responded with farm assistance and energy tax reductions that cushioned the impact on western Canada but significantly slowed deficit reduction.[8]

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[7] For a discussion, see Edward A. Carmichael, *New Stresses on Confederation: Diverging Regional Economies*, Observation 28 (Toronto: C.D. Howe Institute, 1986).

[8] See Edward A. Carmichael, "The Mulroney Government and the Deficit," in Andrew B. Gollner and Daniel Salée, eds., *Canada under Mulroney: An End-of-Term Report* (Montreal: Véhicule Press,1988), pp. 228–240.

Fiscal restraint continued in 1987, along with some further monetary accommodation, but at a much slower pace than had been the case in 1986. The government's failure to pursue deficit reduction more aggressively contributed to the Bank of Canada's moving in early 1987 to a more restrictive policy to guard against an acceleration of inflation.

By 1988, fiscal policy no longer focused on deficit reduction; indeed, the personal income tax cuts implemented on July 1, 1988, provided fiscal stimulus in the second half of the year. The Bank of Canada, facing increasing inflationary pressures and strong growth in its monetary aggregates, permitted real interest rates to rise. As interest rates increased in 1988, and as interest payments on the government's $300 billion public debt were pushed higher, the task of reducing the deficit was made more difficult.

Thus, while the change in the mix of monetary and fiscal policy during the 1984–88 period was initially in the right direction, it was too tentative and was largely reversed by the end of the period. As the political will to reduce the deficit eroded, monetary policy, which had been accommodative, had to become more restrictive as the burden of maintaining non-inflationary growth fell increasingly on the Bank of Canada. The failure to continue fiscal restraint was largely responsible for the overheating of the central Canadian economy in 1988 and thus for the rise in interest rates.

The government's inability to maintain the momentum of deficit reduction now poses the most significant macroeconomic vulnerability facing the Canadian economy. The deficit is lower, but at $28.9 billion — or 4.9 percent of GDP in fiscal year 1988–89 — it is at an unprecedented high level after six years of economic expansion. Even with the economy booming in 1988, the government failed to make much progress in cutting the deficit. The debt has continued to grow faster than the economy. The debt-to-GDP ratio increased to about 54 percent in 1988 from about 42 percent when the Conservatives came to power in 1984, and from 27 percent in 1980.

The dollar value of the debt increased to $300 billion in mid-1988 from about $180 billion in 1984, and from about $80 billion in 1980. Based on Department of Finance projections, if the economy keeps growing at about 3 percent in real terms and short-term interest rates do not exceed 8 percent, the deficit will continue to decline by 1991 to the neighborhood of $20 billion and the debt-to-GDP ratio will stabilize at 56 percent of GDP.[9]

Slower growth, higher interest rates, or some combination of the two would lead to significantly higher deficits than the Department of Finance projects.[10] In this event, the debt-to-GDP ratio would not stabilize but continue to rise, surpassing 60 percent of GDP.

The government made a start at tackling the federal deficit, but a significant challenge remains. The object is not to pursue deficit reduction for its own sake. Rather, it is to shift to a tighter fiscal policy, in order to reduce upward pressure on interest rates and sustain solid economic growth without inflation. The government needs to renew its efforts in this direction.

Structural Policies

Structural policies — including regulation, competition policy, privatization, and science and technology policies — attempt to improve economic performance by encouraging a more efficient use of the economy's resources in individual markets. The Conservative government's approach represented a significant departure from that of the previous government. It designated the private sector as the engine of economic growth, to be fuelled by competitive forces in domestic and international markets rather than by government intervention.

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[9] Department of Finance, *The Fiscal Plan* (Ottawa, 1988), p. 11.

[10] See "Sensitivity of the Government's Fiscal Position to Alternative Economic Assumptions," in Ibid., pp. 81–83.

Regulation

Although regulatory reform was not a high priority in the *1984 Agenda,* the government amassed an impressive legislative record in this area. The accomplishments range from the expected restructuring of the Foreign Investment Review Agency (FIRA) and the dismantling of the National Energy Program (NEP) to the unexpected, significant reforms of transportation and financial regulations.

Foreign Investment. The replacement of FIRA with Investment Canada was one of the government's first acts. It was meant to send a signal to domestic and foreign investors alike that Canada intended to adopt a more welcoming attitude toward private investment. Unlike FIRA's defensive role of screening foreign investment, Investment Canada's mandate was shifted toward promoting Canada as a place to invest.

Among the substantive legal changes was the useful distinction made between new investment and takeovers of existing assets. The new rules exempted new investment from review, with the exception of investments in cultural industries. On existing assets, Investment Canada set a threshold of $5 million as the minimum size of takeover subject to review. As the C.D. Howe Institute has argued previously, however, this threshold was still low enough to impose a regulatory burden on small businesses that remain subject to foreign investment review procedures.[11]

While the creation of Investment Canada was an important symbolic move, its positive effect on investment is difficult to identify. In maintaining a low threshold for review of takeovers, however, the government did reserve an important bargaining chip for later negotiations on foreign investment with the United States.

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[11] **See Edward A. Carmichael, *Reorienting the Canadian Economy,* Policy Review and Outlook, 1986 (Toronto: C.D. Howe Institute,1985), pp. 10–11.**

Energy. The National Energy Program, introduced by the Liberal government in October 1980, has been described as "a paradigmatic case of the use of regulation as a planning tool."[12] It entailed the use of almost every available regulatory instrument, including grants, subsidies, taxes and tax expenditures, public ownership, export licensing, and oil and gas price controls.

The Western Accord of March 1985 dismantled the NEP by decontrolling oil prices and phasing out the complex and inflexible structure of energy taxes and subsidies. By 1986, the Conservative government had also moved toward the deregulation of natural gas prices. Its goal was to introduce a market-oriented energy policy framework that relies on market prices as the best guide for investment decisions. In 1987, the government went further and reduced the National Energy Board's role in regulating oil and natural gas exports.

Changes that have taken place in world energy markets since 1985 have already demonstrated the strengths of the market-oriented approach. When the price of crude oil dropped to U.S.$15 per barrel from U.S.$28 per barrel in 1986, the benefits of lower world prices were passed on to Canadian energy consumers. Equally important, by allowing market realities rather than government subsidies to determine industry activity, the Canadian petroleum industry increased its flexibility and productivity, enabling it to weather the difficult period of depressed prices. Critical to the industry, however, is the certainty that the market-oriented approach to energy pricing will continue and that the way governments tax the energy sector will remain stable.[13] It was in seeking this greater degree of certainty and stability that the industry approached the free trade negotiations.

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[12] Richard Schultz, "Regulating Conservatively: The Mulroney Record, 1984–88," in Gollner and Salée, eds., *Canada under Mulroney*, pp. 193–194.

[13] For a discussion of this point, see Energy Options Advisory Committee, *Energy and Canadians into the 21st Century* (Ottawa: Supply and Services Canada, 1988), pp. 65–93.

Deregulation of the energy sector was one of the easiest but also one of the most beneficial initiatives the government undertook in this area. It removed, at one stroke, a source of great economic inefficiency and intense regional conflict.

The government's announcement of its support and subsidization of several energy megaprojects in the runup to the 1988 election, however, was inconsistent with a market-oriented approach to energy policy.[14] It defended its decisions on the grounds that the megaprojects would promote regional development. But this, too, ran counter to its efforts to adopt more market-oriented regional policies to support small business through the Atlantic Canada Opportunities Agency and the Western Diversification Program. Cynics interpreted the megaproject subsidies as patronage on a grand scale. To the energy industry and to energy consumers, they represented a reminder that energy policy remains vulnerable to political manipulation.

Financial Regulation

With the globalization of world financial markets and the onslaught of fierce international competition, there has been a proliferation of innovative financial services and products. To accommodate these developments, the rules and regulations governing financial institutions have had to change.

This was fully recognized in the *1984 Agenda*: "the current regulatory framework has not come to grips with the evolving needs of the financial community or the public."[15] In the past year, reforms have taken place in response to international pressures and to changes initiated earlier by the provinces, particularly Ontario and Quebec.[16] Still, many other important regulatory matters remain bogged down in debate. Change has centered on creating greater competition among Canada's financial institutions and on minimizing regulatory interference in the flow of capital. Debate has focused on the extent to which Canada should move from the traditional specialized services of particular institutions to a "financial supermarket" approach where financial institutions are permitted to offer a basket of services.

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[14] See Rt. Hon. Brian Mulroney, "Notes for an Address on the Hibernia Development Project," July 18, 1988.

[15] Wilson, *A New Direction for Canada*, p. 37.

[16] For a discussion of Ontario's changes, see Thomas J. Courchene, with John D. Todd and Lawrence P. Schwartz, *Ontario's Proposals for the Canadian Securities Industry*, Observation 29 (Toronto: C.D. Howe Institute, 1986).

Deregulation of the financial sector in Canada is taking place in two discernible phases: (1) the elimination of the historical separation of ownership of commercial banks and securities dealers, and (2) the ability of all types of financial institutions to offer a broader range of services, thereby enhancing competition within the sector.

Under phase one, which has been in effect since June 1987, federally regulated financial institutions — the chartered banks — have been given the right to own securities dealers. Rules in place since June 1988 also allow foreign-owned financial institutions to own Canadian securities dealers. In the past, the policy objective of a stable and independent financial community was achieved by protecting each of the community's four pillars — banks, investment dealers, insurance companies, and trust companies — from competition from one another. The new rules only partly dissolve this separation. By allowing commercial banks to own investment dealers, the range of financial services offered by banks is expanded, but commercial banking and investment banking activities will continue to be regulated separately.

This new operating environment puts Canadian banking and securities firms well ahead of their U.S. counterparts, which are still restricted from engaging in each other's activities. There is, however, pressure on the United States to make its regulations conform more with those of world financial markets.

The importance of the phase one reforms can be evaluated by observing the industry's reactions to the legislation since it was passed in June 1987. There has been a wave of mergers and acquisitions between the chartered banks and the large securities dealers, with five of Canada's six largest banks having joined with Canada's big investment dealers. Several mergers involving foreign firms have also taken place. It would appear that scale economies — in this case, the need to have access to large pools of capital — have obliged securities dealers to join with the banks in order to expand their capital bases and to remain competitive in the global marketplace.

The second phase of financial deregulation awaits consensus and legislative approval.[17] Debate has centered on how the four pillars can offer competitive services while retaining prudential standards and avoiding conflicts of interest. For example, if nonbanks are permitted to compete with banks for personal deposits, it is essential that the same reserve requirements apply to both types of institutions. The potential for conflicts of interest and "self-dealing" (non-arm's-length transactions) increases as the functional separation of the four pillars diminishes and ownership rules are relaxed.

The second phase of financial regulation reform needs to resolve several issues. First, the legislation should set out a level playing field for competition among the four pillars that ensures prudent behavior on the part of all. Second, the legislation must determine ownership rules both among the pillars of the financial sector and between financial institutions and commercial/industrial enterprises. Third, the legislation must provide effective rules to prevent self-dealing, particularly if ownership rules are further relaxed.

Phase one reforms of the financial sector are now complete. Phase two reforms remain unsettled. There is some urgency in moving quickly toward a consensus on the shape and direction these reforms should take. The pressure to move ahead on these long overdue reforms is mounting. Until changes are introduced, much of the financial industry will continue to operate in an environment of considerable uncertainty.

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[17] See Sonita Horvitch, "Financial Reforms Falter at Key Stage," *Financial Post*, September 12, 1988, p. 43.

Transportation Regulation

The central theme of federal transportation policy, as with most of Canada's economic policies, traditionally has been nation building, with a consequent high level of government involvement.

The transportation sector has always played an important role in influencing Canadian competitiveness in both domestic and export markets. This influence has also helped shape Canada's regional economic growth prospects. This was fully recognized in the *1984 Agenda,* which set out general ways to increase the efficiency of the transportation sector and which promised to modernize the rules to meet the realities of ever-changing market conditions.

Historically, Canada's transportation policy has been directed toward encouraging an efficient east-west network. This approach failed, however, to provide investment incentives, to encourage the use of the most efficient modes of transportation, and to encourage competition between and within modes. For example, rail freight subsidies provided under the *Western Grain Transportation Act* — last year costing taxpayers $870 million — discourage the shipment of grain by more cost-effective means.[18]

In keeping with its overall economic strategy, the government, by deregulating the transportation sector, is beginning to let market forces guide resource allocation by encouraging increased competition both within and among the different transportation modes.[19] The new legislative framework to house the new regulatory reforms is the revamped *National Transportation Act*, a new *Motor Vehicle Transport Act*, both in force since January 1988, and a new *Shipping Conferences Exemption Act*, effective since December 1987.

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[18] Economic Council of Canada, *Handling the Risks: A Report on the Prairie Grain Economy* (Ottawa: Supply and Services Canada, 1988), p. 61.

[19] Hon. Don Mazankowski, *Freedom to Move: A Framework for Transportation Reform* (Ottawa: Supply and Services Canada, 1985).

Deregulation in the transportation sector has been comprehensive, involving the air, rail, trucking, and marine industries. In each of these areas, adjustment to a less regulated environment has been relatively smooth. This is largely because changes to the rules were phased in gradually, allowing competitors to adjust fully to anticipated and actual changes to the regulatory environment.

The government's market-oriented approach to transport regulation has had two main thrusts. First, competition within each industry was increased through easier entry and exit controls. For the airline industry, this meant that the need to show "public convenience and necessity" was replaced with a "fit, willing, and able" requirement. In the interprovincial trucking business, it meant the implementation of what is known as a "reverse onus test" — that is, existing firms must show that the entry of a rival firm will harm the public interest. The previous test required new entrants to prove that their participation would be beneficial.

Second, competition among the various transportation industries was increased through the removal of standardized published rates and collective rate setting — the practice of establishing common rates. The new regulations allow the carrier and customer to negotiate in confidence a price and a package of services.

Thus, transportation policy has been reformed to reflect, on the one hand, the maturity of the Canadian transport sector and, on the other hand, the need for greater efficiency through competition between and within industries, and the need to compete with foreign providers of transport services. The new regulatory environment goes far toward achieving these objectives.

Agriculture

The importance of agriculture as an issue during the Conservative government's first term was largely unanticipated in 1984. It certainly did not receive much attention in the *1984 Agenda*. Global developments over the past four years, however, have raised the priority given to agriculture in terms of both government spending and policy activity. Federal spending on agriculture mushroomed to over $6 billion in 1988 from $2.8 billion in 1983.[20]

Farm spending increases occurred in reaction to a deterioration in global market conditions, which was beyond Canadian control. Largely because of international subsidies, which led to the overproduction of grains and other traded commodities, the international price of grain declined to less than $3 per bushel in 1987 from a peak of $6 per bushel in 1981. In real terms, the price of wheat reached its lowest point in Canadian history during the 1986–87 crop year, lower even than in the 1930s.

Overproduction has also intensified competition in export markets. So far, Canada has been able to maintain its share of world grain markets. Canadian exporters face significant competition, however, from subsidized European and U.S. grain in many traditional markets, which could erode future sales.

Price declines have contributed to a serious farm debt situation in Canada. In the 1970s, overinflated land values owing to temporarily high grain prices led to a flurry of farm lending. In the 1980s, farmers saw the value of their equity plummet, and depressed commodity prices and poor harvests have eroded their ability to service their debts. Recent studies estimate that 25 percent of farmers are in financial difficulty and 10 percent are considered "nonviable" because their expenses exceed their income.[21]

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[20] Oliver Bertin, "Farm Income Outlook Bright This Year, Clouded Next," *Globe and Mail* (Toronto), December 13, 1988, p. B11.

[21] See, for example, Economic Council of Canada, *Handling the Risks*, pp. 44–45.

Table 5
Farm Income in Canada by Market and Program Sources, 1981–88
($ billions)

	Cash Receipts					**Realized Net income**[a]
	Total	**Market receipts**		**Gross direct program payments**		
1981	$18.9	$17.9	94.4%	$1.1	5.6%	$3.8
1982	19.1	18.0	94.1	1.1	5.9	3.5
1983	19.0	17.9	94.4	1.1	5.6	3.3
1984	20.7	19.0	91.6	1.7	8.4	4.3
1985	20.4	18.2	89.2	2.2	10.8	3.9
1986	21.1	18.2	86.0	2.9	14.0	4.2
1987	21.4	17.6	82.2	3.8	17.8	4.8
1988	22.4	18.6	82.9	3.8	17.1	5.2

[a] Total cash receipts plus income in kind less total operating expenses and depreciation charges.

Source: Department of Agriculture, Policy Branch, unpublished data.

Without government action, conditions in international farm markets would have translated into serious revenue losses and financial failure for many Canadian producers. The federal government's response to these difficulties has been to subsidize farmers for the extent to which depressed prices have fallen short of maintaining historic income levels. As such, farm income has remained stable and has even increased in recent years, but government transfers account for an increasing share of that income.

Table 5 shows that government program payments as a percentage of total cash receipts increased to 17.1 percent in 1988 from 5.6 percent in 1981. Net farm income reached a record high in 1988 of $5.2 billion, with market returns rising largely due to higher grain prices and government payments rising in spite of a reduced number of farmers in the industry and an easing of the farm debt situation. If government payments as a share of gross cash receipts had remained in the 5–6 percent range of the early 1980s, net farm income in 1988 would have been lower by approximately $2.5 billion, bringing it below levels of earlier in the decade.

Federal agricultural spending has been directed principally at the grains sector in western Canada. Other sectors have been largely unscathed by international market conditions, either because they remain protected by domestic import quotas and supply management, as in the case of the dairy, poultry, and egg sectors, or because market conditions remain relatively positive, as in the livestock industries.

Trade policy has also been a major component of Canadian agricultural strategy over the past four years. The Free Trade Agreement with the United States will ensure more stable markets for livestock, feed grains, and some processed products. The Agreement does not address fundamental concerns in the agricultural sector, however, the origin of which lie in international markets.

The federal government has devoted considerable energy to the resolution of the farm subsidy crisis through the General Agreement on Tariffs and Trade (GATT), at Economic Summit meetings, and in other international forums. Canada is a leading member of the Cairns Group of "fair traders",[22] which is attempting to bridge the gap between the divergent views of the United States and the European Community to agricultural trade reform. In consultation with other members of the Cairns Group, Canadian officials are working to develop a consensus on the measurement of trade-distorting subsidies, some rules on national agricultural programs, and a strategy for reducing agricultural assistance.

Government agricultural policy during the 1984–88 period evolved more as a reaction to unfolding events than as a result of a preconceived strategy. This is understandable, in light of Canada's high exposure to export markets and limited capacity to influence world market conditions. The Canadian policy response — to maintain the status quo in incomes and production patterns — represents a shielding of Canadian agriculture from world market conditions, not an adjustment to them. The cost of preserving the status quo has been high and threatens to be higher still if this objective is pursued in the future. In its next term, the government should begin the difficult task of encouraging Canadian agriculture to adjust to the new global market realities.

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[22] The other members of the Cairns Group are Argentina, Australia, Chile, Colombia, Brazil, Hungary, Indonesia, Malaysia, New Zealand, the Philippines, Thailand, and Uruguay.

Competition Policy

Competition improves the economy's dynamism and helps to ensure a more efficient allocation of its scarce resources. It does this by forcing firms to use the most cost-effective inputs and production processes. It also prevents firms from exploiting consumers by charging more than competitive prices. For this reason, an effective competition policy is an important cornerstone of Canada's economic policy.

The antiquated nature of the *Combines Investigation Act,* which provides the framework for Canada's competition policy, had long been recognized. The old policy was ineffective in dealing with mergers, acquisitions, or monopolies that adversely affect competition. This was a serious problem, given Canada's small domestic market and highly concentrated market structure. In the 77-year history of the Act, only a single monopoly case had ever been prosecuted successfully, and all of the nine merger cases brought before the courts were vindicated. The failure to prosecute business activities that lessened competition resulted from the onerous burden of proof required for conviction under criminal law standards.

Previous attempts — in 1971, 1977, 1979, and 1984 — to change the Act had met with resistance from the business community. Yet the wave of mergers that occurred in the mid-1980s created a belief that there was an urgent need to adopt more effective laws in this area, and the Conservative government placed a high priority on the implementation of a new *Competition Act* in its *1984 Agenda.* In 1986, the government succeeded in passing a new Act that represented a consensus view on the direction of Canada's competition laws.

Without doubt, the new Act represents an improvement over the previous legislation. It makes Canada's laws more effective and (likely) more enforceable through two significant changes. First, a specialized Competition Tribunal was created to adjudicate proceedings. Second, jurisdiction over mergers, acquisitions, and monopoly was transferred from the realm of criminal to civil law.

The creation of the Tribunal, a quasi-judicial body, appears to be a reasonable compromise between those who prefer that the courts adjudicate competition matters, since they produce consistent results, and those who prefer more responsive decisionmaking in light of the realities of constantly changing economic developments.

The new Act's treatment of mergers, acquisitions, and monopoly as matters of civil law now means that the statutory test is whether or not the proposed or existing amalgamation "substantially lessens competition." This is in contrast to the old provisions, which required prosecutors to prove the undertaking was detrimental to the public — a burden of proof that was insurmountable. The new legislation is superior in that it now explicitly recognizes economic factors relating to amalgamations.

In the past, the sole criterion for objecting to mergers was based on market shares or concentration levels. Reliance on this test alone, as a measure of competition, was and remains misleading, for three major reasons. First, some mergers and acquisitions are beneficial, particularly in cases where gains in efficiency through scale economies more than offset the lessening of competition. Second, concentration levels alone do not give an accurate picture of the extent of competition in any individual market. Third, in today's global economy, domestic concentration ratios are often misleading indicators of the degree of competition. Under the new legislation, review of amalgamations now takes into consideration such factors as:

Table 6
Disposition of Proposed Merger Transactions under the Competition Act, June 19, 1986–January 15, 1988

Number of proposed merger transactions[a]	1,630
Number not requiring significant review	1,479
Number requiring significant review[b]	151
Number concluded as posing no issue under the Act	74
Number given Advanced Ruling Certificate, which allows a merger to proceed because no competition concerns arise	23
Number processed under the Program of Compliance, which allows a merger to proceed under the supervision of the Director of Investigations	23
Number abandoned because of Director's position — for example, that a merger would lessen competition	5
Number referred to the Competition Tribunal	2
Number of cases still ongoing	24

[a] These statistics relate to mergers and acquisitions that were either proposed or completed. In some cases, proposed transactions were not completed for reasons unrelated to the decisions of the Director of Investigations.

[b] Defined as those cases in which more than two person days have been spent reviewing the transaction.

Source: R.S. Khemani, "The Competition Act and Corporate Mergers," *Canadian Business Review* 15 (Spring 1988): 34.

- the effective competition after the merger;
- the degree of international competition;
- barriers to entry into the industry;
- the extent and availability of substitutes;
- whether the firm acquired is a failing business or an effective and vigorous competitor; and
- whether, in merger cases, the efficiency gains resulting from the merger would more than offset the lessening of competition that might result.

Canada sorely needed a new *Competition Act*. The new Act already has succeeded where its predecessor failed. Table 6 shows the results for the first two years of operation. The legislation should be seen in a positive light for its greater reliance on market forces to drive economic growth, and on efficiency to improve the functioning of markets.

Privatization

Privatization — the sale of Crown assets or the contracting out of services previously provided by government — was not a significant aspect of the *1984 Agenda*. While the government pledged to review the mandate and management of Crown corporations, it did not contemplate large-scale sales of such corporations.

Professor William Stanbury, of the University of British Columbia Business School, has chronicled the government's privatization record during the 1984–88 period.[24] He notes that it was not until 1987 that the government actually laid out the reasons why it was pursuing privatization. The key rationale was that Crown corporations should be returned to the private sector if the original public policy objectives behind their creation were no longer valid. Other reasons included the potential for improving efficiency, for reducing the demands on public funds, for infusing more flexible and decisive management, and for reducing subsidized competition against firms in the private sector.[25]

Table 7 lists the government's privatizations during the 1984–88 period. Including the sale of 45 percent of the equity of Air Canada in late 1988, it sold 13 Crown investments during this time for approximately $2.2 billion.

Prior to the Air Canada sale, the government's privatization efforts were modest. The first large privatization — Canada Development Corporation (CDC) — represented the

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[24] William T. Stanbury, "Privatization and the Mulroney Government, 1984–1988," in Gollner and Salée, eds., *Canada under Mulroney*, pp. 119–157.

[25] Hon. Barbara McDougall, "Luncheon Address to the B.C. Politics and Privatization Conference," Vancouver, May 21, 1987.

Table 7
Privatizations in Canada, 1984–88
($ millions)

Corporation	Year of Sale	Revenue[a]	Sale Price
Northern Transportation Company Limited	1985	41	27
Canada Development Corporation (48.2%)	1985–87	3,257	377
CN Route	1986	145	29
Canadair Limited	1986	451	205
Canadian Arsenals Limited	1986	103	92
de Havilland Aircraft of Canada, Limited	1986	300	155
Nanisivik Mines Limited (18%)	1986	26	6
Pêcheries Canada Inc.	1986	16	5
Fishery Products International Limited	1987	387	104
Northern Canada Power Commission	1987	19	20
Teleglobe Canada	1987	274	488
Air Canada (45%)	1988	3,130	300
CN Hotels Inc.	1988	147	265

[a] Revenue figures are for the year prior to the sales.

Source: William T. Stanbury, "Privatization and the Mulroney Government, 1984–88," in Andrew B. Gollner and Daniel Salée, *Canada under Mulroney: An End-of-Term Report* (Montreal: Véhicule Press, 1988), p. 127.

conclusion of a sale begun by the previous Liberal government. Excluding CDC, there were just four substantial privatizations prior to Air Canada — de Havilland, Canadair, Teleglobe, and CN Hotels. The rest were relatively small deals. Among the larger privatizations, the de Havilland and Canadair sales were made possible only when the government agreed to absorb their debt. But the return of these companies to private-sector management both brightened their future prospects and eliminated a large federal budgetary drain.

Excluding CDC, the government disposed of $3.5 billion in gross assets, a small amount compared with the $77 billion in gross assets that the Auditor General estimated Crown corporations to be worth in mid-1984. While these assets bear little resemblance to the market value of Crown investments, they do indicate that the government has made only a small beginning in its privatization program.

Stanbury points out that the government has sold most Crown corporations to single buyers in the private sector rather than through wide distributions of shares to the public. He also notes that the government has made little effort, except in the Post Office, to privatize public services through contracting out. While the task of privatization has begun, more needs to be done if the program is to represent anything more than a brief pause in the buildup of Crown activity in the commercial sector.

Science and Technology Policy

One of the foundations of economic renewal, according to the *1984 Agenda,* is stronger Canadian performance in research and development and technological innovation.

The government argued that to be competitive, Canadian industry had to step up its R&D efforts, not only to produce new technologies but also to allow for speedier adoption of imported know-how. The government saw its role as creating the necessary climate for increased innovation by:

- rationalizing the 37 federal programs concerned with science and technology;
- increasing the market relevance of federal contributions to technology funding;
- broadening the definition of R&D for tax purposes; and
- examining the potential of government-financed technology centers, and industry-wide private/public research efforts.[26]

In the wake of the $2 billion Scientific Research Tax Credit boondoggle and with top priority accorded to deficit reduction, the government's fiscal capacity to provide new financial incentives to encourage R&D and innovation was limited. In line with the consultative route that the government adopted in several policy areas, it sought and received in 1985 a commitment from federal and provincial ministers responsible for science and technology to develop a National Science and Technology Policy. In June 1986, the government sponsored a National Science and Technology Forum, which included representation from industry, labor, universities, and community colleges.

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[26] Wilson, *A New Direction for Canada*, pp. 25–27.

In March 1987, the government's National Science and Technology Policy was unveiled. Its stated objective was "to bring science and technology fully to bear on the economic, social, cultural and regional development of our country, by encouraging cooperation among governments, and between the public, quasi-public and private sectors."[27] The six key elements of the policy are commitments to:

- improve industrial innovation and technology diffusion;
- develop strategic technologies in areas where Canada can excel internationally;
- ensure the necessary pool of highly qualified people;
- support basic and applied research and development;
- deal with the impact of technological change on society; and
- promote a more science-oriented culture.

The government announced no immediate actions to implement the new policy. Instead, it established a number of working groups to study and report on actions that might be taken to achieve the objectives.

In early 1988, the prime minister convened another high-level meeting on science and technology, and announced an additional $260 million per year to create "Centres of Excellence" in universities and to provide scholarships in science and engineering.[28]

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[27] Ministry of State for Science and Technology, *The National Science and Technology Policy: Background Paper* (Ottawa, 1987), p. 6.

[28] Rt. Hon. Brian Mulroney, "Notes for an Address at the Opening of the National Conference on Technology and Innovation," Toronto, January 13, 1988.

The government has undertaken a great deal of consultation and consensus-building on the need for new approaches to science and technology policy, but it has not increased federal R&D subsidies. This partly reflects Canada's difficult fiscal situation. More importantly, it reflects growing recognition that improving the quality and results of Canada's R&D is more important than increasing the level of R&D spending. In this environment, science and technology policy advocates have sought to identify new, less government-directed approaches to strengthen Canada's science and technology base. In particular, the embryonic development of closer, more effective government-industry-university linkages is one positive development. Greater attention to science education in Canadian schools is another. While promising, these steps do not yet constitute a viable new approach to science and technology policy in Canada.

Trade Policy

Since 1935, Canada's trade policy has evolved along two distinct but parallel paths. The Conservative government continued this approach when it promised in its *1984 Agenda* to investigate options for bilateral trade liberalization with the United States and to push for a new round of multilateral trade negotiations through the GATT.

The pressures to act were intense. In the United States, with its trade balance in deficit with virtually every one of its trading partners, industries began pressing for measures to reduce import penetration through nontariff protection. The U.S. government responded to these protectionist calls by, for example, limiting steel imports through voluntary restraint agreements with steel exporters, imposing countervailing duties against Canadian Atlantic ground fish and softwood lumber, and undertaking a safeguard action that slapped a 35 percent duty on Canadian cedar shingles and shakes. These and other acts of U.S.-administered protection reduced Canada's access to its largest export market and raised the specter of further reductions in market access.[29] Free trade with the United States, therefore, which was to become the centerpiece of the government's economic agenda, is best interpreted as Canada's response to U.S. protectionism rather than as an ideologically motivated initiative. Box 1 gives a brief chronology of the free trade initiative.

The Canada-U.S. Free Trade Agreement in Brief

The main theme of the Canada-U.S. Free Trade Agreement is to establish and to preserve liberalized trade between the two countries. The Agreement does this by adopting and, where appropriate, extending the principles and international trading rules of the GATT. Many clauses — including some of those that have come under severe criticism — merely repeat obligations the two countries already have undertaken by virtue of their membership in the GATT. The Agreement goes beyond the GATT, however, by including important trade-liberalizing measures in agriculture, services, energy, business travel, and safeguard measures.

The two most important principles of the Agreement, and which are also embodied in the GATT, are national treatment and the "grandfathering" provision. Both allow Canada to preserve its sovereignty by maintaining policy independence and by protecting existing laws that discriminate in favor of Canadians.[30]

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[29] See Alan M. Rugman, *Administered Protection: U.S. Trade Law as a Nontariff Barrier to Trade*, Dalhousie Discussion Papers in International Business 58 (Halifax, N.S.: Dalhousie University, Centre for International Business Studies, 1986).

[30] For a detailed analysis of the sovereignty issue and how the Agreement preserves Canada's policy independence, see Richard G. Lipsey, *The Free Trade Deal and Canada's Sovereignty: Are the Fears Justified?*, Trade Monitor 8 (Toronto: C.D. Howe Institute, 1988).

Box 1
A Chronology of the Canada-U.S. Free Trade Negotiations

Date	Event
March–May 1985	International Trade Minister James Kelleher holds hearings on Canada's trade options and reports significant support for negotiation of a comprehensive Canada-U.S. free trade agreement.
August 1985	Parliamentary Committee on Canada's International Relations recommends that Canada initiate bilateral trade negotiations with the United States.
September 1985	Prime Minister Mulroney announces that the United States has agreed to undertake free trade negotiations.
December 1985	President Reagan notifies the U.S. Congress of the administration's intent.
May 1986	Canadian and U.S. negotiators meet for the first time in Ottawa to discuss the organization of trade talks.
September 1987	Canada breaks off negotiations because "the U.S. is not responding on elements fundamental to Canada's position." Ministerial-level meetings between the two governments are held to decide if talks should resume.
October 1987	Talks resume and a preliminary Agreement is struck in the eleventh hour of negotiations.
December 1987	Final Text of the Agreement is published.
January 1988	Prime Minister Mulroney and President Reagan initial the Agreement.
October 1988	The U.S. Congress ratifies the Agreement.
December 1988	Parliament passes the implementing legislation to enact the Agreement as of January 1, 1989

National treatment allows Canada to adopt any new policies, rules, or regulations that it wishes, so long as they are not used as concealed trade barriers, and so long as Canada applies these policies equally to Canadian and U.S. firms operating in Canada. The grandfathering provision ensures that the principle of national treatment applies only to new laws, not existing ones, by leaving in place most existing programs, practices, and policies that currently discriminate between foreign and domestic firms and products.

The object of the Agreement is to improve the access of each country's exporters to the other country's market. The Agreement achieves this objective by providing for a major liberalization of trade and for the removal of many trade irritants. For Canadian producers, it increases their access to the U.S. market, it makes that access more secure, and it promises to add to that security in the future.[32]

The Agreement increases access in 18 identifiable ways, running from the complete removal of tariffs on all trade in goods to the easing of border crossings for business and service personnel, whose frequent harassment at the border is a significant nontariff barrier.

It makes access to the U.S. market more secure in eight different ways, two of which are important gains. First, it places severe constraints on emergency actions to stop surges of Canadian exports to the United States. Second, the Agreement's prohibition of quota restrictions ends their threatened use by the United States as a means of persuading Canadian firms to restrain their exports through voluntary export restrictions, as in the case of specialty steel.

Another advantage of the Agreement is that it incorporates dispute settlement mechanisms that are superior to those available in the GATT. Disputes on the operation of the

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[32] For a detailed discussion, see Richard G. Lipsey and Robert C. York, *Evaluating the Free Trade Deal: A Guided Tour through the Canada-U.S. Agreement*, Policy Study 6 (Toronto: C.D. Howe Institute, 1988), pp. 13–18.

Agreement are to be overseen by a cabinet-level committee and referred, if necessary, to a binational arbitration panel. A binational panel will also replace judicial review of both countries' domestic fair-trade laws. This binational appeal process is superior to the status quo for two reasons: a fixed timetable shortens the appeal procedure, and the possibility of binational scrutiny should increase the objectivity of the domestic decisionmaking process.

The Agreement promises future increases in security of access by mandating negotiations, over the next five to seven years, on a code for subsidy and antidumping procedures.

Finally, the Agreement frees up trade in covered services — commercially traded services such as business consulting and insurance — by virtue of its granting them the right of establishment and national treatment. Trade in services has become such an increasingly important component of bilateral trade that its inclusion in the Agreement was highly desirable. This pathbreaking part of the Agreement may set the tone for further multilateral GATT negotiations in this sector. The Agreement also provides an exemption for "noncovered" services — services not covered by the terms of the Agreement — which include most government-produced services such as hospitals, education, and child care.

The Uruguay Round of Multilateral Negotiations

In the multilateral arena, Canada, along with the other 95 members of the GATT, began negotiations on a new multilateral Round in Punta del Este, Uruguay, in September 1986. A Midterm Review of progress on the negotiations took place in Montreal in December 1988, and the Round is due to end in 1990.[33]

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[33] For a discussion, see Sidney Golt, *The GATT Negotiations, 1986–90: Origins, Issues and Prospects,* BNAC 36 (London: British-North American Committee, 1988).

The Uruguay Round is the eighth such Round to reduce trade barriers since 1947. Negotiations take place as a group or bilaterally, on the understanding that reductions in tariff or nontariff barriers will be extended to all GATT members on a "most-favored-nation" basis.

The likelihood of success in the Uruguay Round will depend on the objectives, expectations, and negotiating positions of the GATT's many members. Previous Rounds of trade negotiations have had specific negotiating themes. For example, the Kennedy Round (1963–67) addressed tariffs, while the Tokyo Round (1973–79) focused on nontariff barriers. The current Round is ambitious. It covers 15 negotiating areas (shown in Table 8), including, for the first time, agriculture and services.

External Affairs Minister Joe Clark spelled out the objectives of the Uruguay Round at the Punta del Este meeting:

- curb and then roll back protectionist measures;
- improve access to foreign markets, particularly in upgraded natural resource products;
- reform the rules for agricultural trade;
- increase the discipline of GATT dispute settlement and surveillance;
- address new issues, such as trade in services;
- strengthen the GATT as an institution; and
- tighten discipline on the use of contingency protection.[34]

Changes in the international marketplace continue to force Canada to look outward to secure market access and to enhance its economic growth. The Free Trade Agreement and continuing efforts to pursue access to foreign markets through multilateral trade negotiations ensure that Canadian policies will continue to be outward-looking. Trade policy has taken

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[34] Rt. Hon. Joe Clark, "Notes for a Speech to the Ministerial Session of the Contracting Parties," Punta del Este, Uruguay, September 15, 1986.

Table 8
Major Issues in the Uruguay Round of Multilateral Trade Negotiations

Negotiating Group	Key Negotiating Issue
Tariffs	Reduce and/or eliminate high tariffs and tariff escalation.
Nontariff Measures	Reduce or eliminate nontariff measures, including quotas and government procurement practices.
Tropical Products	Liberalize trade in tropical products by tariff and nontariff measures.
Textiles	Integrate this sector into GATT based on strengthened GATT rules and disciplines.
Natural Resource-Based Products	Deregulate trade in natural resources, including processed and semiprocessed forms through tariffs and nontariff measures.
Agriculture	Deal with the proliferation of agricultural subsidies; improve market access through reductions in import barriers.
GATT Articles	Review existing GATT Articles and undertake any appropriate negotiations.
Services	Establish a multilateral framework for trade in services.
Safeguards	Move toward a comprehensive agreement on their use to strengthen the GATT system.
Subsidies and Countervailing Duty Measures	Review GATT Articles respecting these measures, in order to improve GATT discipline.
Dispute Settlement	Improve and strengthen the effectiveness of rules and procedures of the GATT's dispute settlement mechanism.
Trade-Related Aspects of Intellectual Property Rights	Extend GATT principles to international trade for the protection of copyrights, patents, and trade in counterfeit goods; ensure that intellectual property rights do not themselves become barriers to trade.
Trade-Related Investment Measures	Eliminate or reduce trade-restricting and distorting effects of investment measures — for example, domestic performance requirements.
Functioning of the GATT System	Enhance surveillance; improve overall effectiveness; greater contribution by strengthening ties to other international bodies.
Multilateral Trade Negotiation Agreements and Arrangements.	Clarify and expand Agreements and Arrangements negotiated in the Tokyo Round; examine proposals made by participants, with a view to clarifying issues on which negotiations are appropriate.

an important step forward. Canada is now an active player in the process, and can only gain from pushing the trade-liberalization movement forward into the 1990s. In so doing, it will help to ensure that Canadian industry continues to prosper, and that employment, economic activity, and real incomes continue to grow.

Tax Reform

The federal government's 1984 tax reform agenda was relatively modest: to review industrial benefits delivered through the tax system and to work toward simplification of the system, particularly as it relates to small business.

In the May 1985 budget, the government adopted a minimum personal tax and proposed a reform of the corporate income tax that would lower the corporate tax rate to 33 percent from 36 percent and broaden the corporate tax base by eliminating the inventory allowance and phasing out the general investment tax.[33] These proposals amounted to a piecemeal approach to tax reform that was motivated by political pressures and the government's desire to shore up its eroding corporate tax base.

In December 1985, the C.D. Howe Institute argued in favor of a more comprehensive approach to tax reform that would incorporate needed changes in personal, corporate, and sales taxes.[34] It was not until mid-1986, however, when it suddenly became apparent that the United States would undertake comprehensive changes to its tax system, that tax reform became a priority in Canada. Within weeks, Finance Minister Michael Wilson announced that Canada would scrap the piecemeal approach to tax reform and bring forward a comprehensive plan for overhauling not only personal and corporate income taxes but also the federal sales tax.

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[33] Hon. Michael H. Wilson, *The Corporate Tax System: A Direction for Change* (Ottawa: Department of Finance, May 1985).

[34] Edward A. Carmichael, *Reorienting the Canadian Economy,* Policy Review and Outlook, 1986 (Toronto: C.D. Howe Institute, 1985), p. 84.

Prior to the U.S. reform, the leading tax reform issue in Canada had been the replacement of the antiquated manufacturers' sales tax with a new, broad-based, multistage tax. Indeed, a *White Paper* on sales tax reform had been expected in the spring of 1986, but concerns about its potential political unpopularity and the U.S. momentum toward comprehensive tax reform scuttled plans for its release.

The *White Paper on Tax Reform* was released a year later, as Canada's response to the U.S. reform.[35] Improving Canada's tax competitiveness relative to the United States was a major objective of the *White Paper.* This was partly out of concern that lower U.S. tax rates would attract mobile individuals and capital to locate in the United States. Equally important, however, was the concern that corporations would rearrange their affairs in ways that would shift income to the United States, where it would be taxed at lower rates, and shift deductions to Canada, where tax savings would be larger. Department of Finance officials recognized that since this could lead to a significant erosion of corporate income taxes in Canada, it required a response.[36]

The response came in the form of a three-pronged reform in two stages: Stage I — changes to the personal and corporate income tax, which would proceed immediately — and Stage II — sales tax reform, which was delayed again pending further discussion with the provinces.

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[35] Hon. Michael H. Wilson, *The White Paper on Tax Reform* (Ottawa: Department of Finance, June 1987).

[36] David Dodge and John Sargent, "Canada," in Joseph A. Pechman, ed., *World Tax Reform: A Progress Report,* Brookings Dialogues on Public Policy (Washington, D.C.: Brookings Institution, 1988), pp. 43–69.

Stage I Tax Reforms

The Stage I reforms countered U.S. tax changes by lowering Canadian tax rates and by broadening personal and corporate tax bases in order to shift the tax burden away from the personal and toward the corporate tax.

Personal income tax rates, which had covered ten brackets ranging from 6 to 34 percent, were changed to three brackets of 17, 26, and 29 percent. Personal exemptions and some deductions were replaced with nonrefundable tax credits, a change which reinforced the progressivity of the personal tax system. The reform also adopted a variety of other base-broadening measures, including the elimination of the $1,000 investment income deduction, a reduction in the $500,000 lifetime capital gains exemption to $100,000 except for farm and small business property, and an increase in the fraction of capital gains included in income for tax purposes to 75 percent from 50 percent.

On the corporate side, the government continued with the rate-reduction and base-broadening measures that it had begun in its 1985 budget. In two phases, it cut the basic corporate tax rate to 28 percent from 36 percent. Tax rates for manufacturing and small business were cut to 23 from 30 percent and to 12 from 15 percent, respectively.

These corporate tax rate cuts were more than offset by base-broadening measures that eliminated the general investment tax credit and reduced capital cost allowances, along with several other measures specific to financial institutions, real estate, and mining. Overall, the corporate tax changes were expected to generate an 8 percent increase in corporate income taxes over the four-year phase-in period.[39]

The Stage I reforms relieved the strongest pressures that the U.S. tax reform had brought to bear. After the government adopted tax increases such as the partial deindexation of the personal tax system and the imposition of personal and corporate surtaxes to help tackle the budget deficit in 1985 and 1986, the *White Paper* reversed the upward drift in marginal tax rates. The new tax credits were more generous to low-income individuals than the personal exemptions and deductions which they replaced, and thereby removed 800,000 low-income taxpayers from the tax rolls. At the same time, some Canadians with modest incomes — particularly the non-elderly with no children — had their tax burden increased over the 1984–88 period. This increase, however, reflected the government's need for additional revenues to cut the deficit. In general, the personal tax reforms accomplished what the government had advertised: lower rates and a fairer system.

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[39] Ibid., p. 61.

The corporate tax reforms also moved the system in the right direction by eliminating tax preferences that had caused wide divergences in effective corporate tax rates across industries. In spite of an increase in the corporate tax burden, the system remains competitive with that in the United States.[40] Small business, for example, continues to have more favorable tax treatment in Canada than in the United States. Generally, Canadian business grudgingly accepted the corporate tax reforms, "if for no better reason than that the proposed changes seemed less devastating and less extensive than had originally been feared."[41] When compared with the tax reform battles of the 1970s, the 1987 reform appears a model of a well-managed reform process.

Shortcomings of the Stage I Reforms

The Stage I reforms, however, did contain some shortcomings. First, personal tax reform failed to address the interaction of the tax system with social program transfers. Under the existing system, low-income individuals who find a job sometimes confront implicit tax rates that exceed 100 percent.[42] This occurs when the value of the taxes paid plus the welfare benefits lost — such as unemployment insurance, housing allowances, free drugs — exceeds the increase in income from the new job. Quebec has embarked on full integration of its tax-transfer system, aiming to create a system in which individuals either receive social assistance benefits from government or pay taxes, but not both at once. In the process, a major poverty trap in the tax-transfer system will be reduced. The federal government missed the window of opportunity provided by personal tax reform to pursue similar objectives.

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[40] David Y. Timbrell, "Tax Reform: Effects on Canada's Tax Competitiveness with the United States," in Edward A. Carmichael, ed., *Tax Reform: Perspectives on the White Paper*, Policy Study 4 (Toronto: C.D. Howe Institute, 1988), pp. 63–74.

[41] Robert D. Brown, "The Impact on Business," in Ibid., p. 49.

Second, income from investment came under heavy attack in the government's reforms.[43] The elimination of the interest and dividend deduction, the reduction in the capital gains exemption, the increase in the inclusion rate for taxable capital gains, the failure to index capital gains (even partially) for tax purposes, and the reduction in the dividend tax credit, all tend to reduce the attractiveness of equity investment for individuals and raise the cost of equity capital for business. While some move in this direction was expected, given the need to broaden the personal tax base, there are solid grounds for arguing that the government moved too far. Together with the corporate tax changes and the tough new anti-avoidance rules, the government has risked souring the investment climate. While there is no evidence yet of a negative impact, a downturn in business investment may bring a future reconsideration of the investment income provisions.

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[42] Thomas J. Courchene, "The Impact on Individuals," in Ibid., p. 26.
[43] Ibid., pp. 29–36.

Third, and most important, the decision to delay sales tax reform was a potentially costly one. The vast majority of Canadian (and foreign) tax specialists regard Canada's existing manufacturers' sales tax as obsolete, arbitrary, and economically damaging.[44] It is difficult to administer and enforce. It hurts Canada's international competitiveness, economic growth, and living standards by penalizing Canadian exports and subsidizing imports.

In spite of years of accumulated evidence that sales tax reform was overdue, the government chose to delay any decision until after the 1988 election. This decision jeopardized sales tax reform by making it a political football in the campaign. Equally important, the decision constrained the Stage I reforms. It prevented the government from going further in reducing personal tax rates for low- and middle-income taxpayers and in removing surtaxes and, in the process, shifting more of the tax burden from income to sales taxes. At the same time, it may have forced the government to go further in attacking investment income than would have been necessary if sales tax reform had been included in Stage I. Finally, it restricted the government's ability to expand the use of refundable tax credits and thereby move the welfare system away from transfers that dull work incentives.

On balance, the government's tax reform initiatives met the most pressing challenges created by U.S. tax reform, but they shied away from confronting some of the worst flaws that have plagued Canada's tax system for many years.

Social Policy

Social policy reform did not figure prominently in the government's *1984 Agenda*. Unlike its intentions in other areas of economic policy, the government appeared to lack a clear view of how to proceed. It cited social and fiscal responsibility as the two principles underlying social policy reform. It also looked, almost hopefully, to employment growth as a means of reducing reliance on the social security system.

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[44] See John Bossons, "Sales Tax Reform: The Delayed Part of the Package," in Ibid., pp. 87–102.

The *1984 Agenda* advocated a better targeting of social programs to low-income Canadians generally. It raised concerns and proposed specific reforms for some areas of social policy. In the elderly and family benefits area, for example, the government considered various options for reducing transfers to high-income recipients and increasing benefits to low-income groups. The document also proposed changes to the Unemployment Insurance system. The *1984 Agenda* did not address important social programs such as pensions and child care, despite promises on the latter made in the 1984 election campaign.

The *1984 Agenda*'s inclusion of social policy in the section on restoring fiscal flexibility implied that the government viewed deficit reduction as an important motivation in the redesign of social programs. The government reinforced this view early in its term by trying to re-examine the case for universal access to social programs. A fierce debate on universality then raged for three months, fueled by the conflicting views of government leaders on the issue.

A document tabled in January 1985 by Health and Welfare Minister Jake Epp brought the debate to an unfruitful end.[45] It committed the government to the preservation of universality and contained the assurance that any saving realized as a result of changes in income security programs would be used within the social policy area, not to reduce the deficit. The badly designed proposal partially to deindex old age security unleashed another stream of protests, however, which forced the government to retreat and the prime minister to admit during the 1988 leaders' debate that a mistake had been made.

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[45] Hon. Jake Epp, *Child and Elderly Benefits* (Ottawa: Department of National Health and Welfare, 1985).

The outcry that accompanied the government's tentative foray into social policy reform made clear the political difficulties associated with change in this area. The government appeared to accept that significant change, along the lines suggested by the Macdonald Commission and others, would be politically too difficult. Although some improvements were made, the government left unresolved many of the most fundamental social policy challenges.

Unemployment Insurance

The government also promised to reform the Unemployment Insurance (UI) system in the *1984 Agenda*. In so doing, it recognized many of the system's faults, including its negative impact on job search, on stable employment, and on labor mobility. Unfortunately, the government did not deliver on its promise.

In 1985, the government established a Commission chaired by Claude Forget to review the program and propose reforms. The Forget Commission's recommendations were similar to those made by the Macdonald Commission, Newfoundland's Howse Commission on Employment, and others.[46] These examinations agreed on the general principles underlying reform: the need to enhance economic adjustment, labor flexibility, and human capital investment. They also concluded that the income security aspects of the current system should be transferred to program better equipped to deliver assistance — ideally, some form of income supplementation plan or guaranteed annual income.

The Forget Commission's report was forwarded to a Parliamentary Committee, which subsequently proposed a series of watered-down changes to the current system. Both sets of recommendations were effectively shelved in May 1987, when the government announced that it would undertake no substantial changes to the UI system.

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[46] Canada, Commission of Inquiry on Unemployment Insurance [Forget Commission], *Report* (Ottawa: Supply and Services Canada, 1986); Newfoundland, Royal Commission on Employment and Unemployment [Howse Commission], *Building on Our Strengths* (St. John's: Queen's Printer, 1986); and Macdonald Commission, *Report*, Vol. 2.

The government's inability to achieve UI reform cannot be blamed on a lack of consensus on the need for reform or the direction that reform should take. Its difficulties were political in nature and arose from at least two quarters.

As Leslie Pal has argued,[47] the UI system is highly entrenched at the constituency level and forms part of the social and economic fabric of many regions. The fundamental principles of the *Unemployment Insurance Act* remain as they were when the legislation was passed in 1971. Every major change proposed since has been loudly attacked by various groups who benefit from the status quo.

The second political difficulty arises from the fact that the provinces gain handsomely under the current system and inevitably would lose from changes to it. The division of social responsibilities in the Canadian federation is such that Ottawa administers UI, while the provinces look after social welfare. Changes to the UI system, along the lines of those proposed by the Macdonald and Forget Commissions, almost certainly would result in a spillover of many recipients to the provincial welfare rolls, thus increasing provincial social welfare expenditures. It is largely for this reason that the provinces have resisted changes to the UI system, making reform even more difficult.

Reform of the UI system is an important piece of unfinished business left over from the government's *1984 Agenda*. Unless significantly altered, the current system will continue to provide inappropriate signals to the labor market, thus discouraging adjustment, flexibility, and the best use of labor resources.

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[47] Leslie A. Pal, "Sense and Sensibility: Comments on Forget," *Canadian Public Policy* 14 (March 1988): 7–14.

Family Benefits

The government questioned the fairness of the family benefits package in its *1984 Agenda,* noting, for example, that low-income families fared worse than middle-income earners under the existing system. It presented several proposals to target benefits better to low-income families. These included:

- phasing out the child tax exemption;
- reducing family allowance payments for high-income families; and
- scaling back both family allowances and the child tax exemptions and using the savings to enrich the child tax credit for low-income recipients.[48]

The 1985 budget made the following changes to the family benefits package:

- an enrichment of the refundable child tax credit;
- a gradual reduction in the child tax exemption to the level of the family allowance transfer; and
- a partial deindexation of family allowance payments.

The reduction of the child tax exemption to the value of the family allowance transfer was equivalent to making family allowances nontaxable. When combined with the enrichment of the refundable child tax credit, the reformed family benefits package preserved universality, but was better targeted and was made more generous to low-income families.

The improved targeting of family benefits is one of the government's most important accomplishments in the social policy area. By better integrating the tax and transfer components of the system and focusing on the after-tax impact of social benefits, it has reallocated expenditures to the benefit of low-income families.

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[48] Wilson, *A New Direction for Canada*, p. 73.

Elderly Benefits

The government's view on the elderly benefits system, as spelled out in the *1984 Agenda*, was that the system was too generous to high-income pensioners and inadequate for the low-income elderly. It proposed several reform options to make the system more progressive:

- steeper tax recovery rates for high-income Old Age Security (OAS) recipients;
- phasing out tax deductions; and
- reducing or eliminating the indexation of the OAS and using the savings to compensate low-income pensioners through the Guaranteed Income Supplement (GIS) or other transfer programs.[49]

It was a version of the latter option that landed the government in political hot water in 1985. Its unwise proposal partially to deindex OAS payments without providing any compensation to low-income GIS recipients gave rise to massive protests from pensioners; the government beat a hasty retreat from the suggestion.

Despite its initial difficulties, the government implemented a number of minor reforms to the elderly transfer system in 1985 and 1986. Spousal Allowance Benefits, introduced in 1985, extended pension benefits to some 85,000 low-income widows and widowers aged 60 to 64. Veterans' benefits were also improved through changes to veterans' pensions, and disability and survivor benefits.

Another focus of government attention was pension reform. Changes to the legislation governing employer-sponsored pension plans provide for shorter vesting periods, increased portability of benefits, a more equitable treatment of female pensioners, and mandatory benefits for surviving spouses. The first two changes are important, not only to pension recipients themselves but to the overall labor adjustment process. More flexible pension plans facilitate the movement of workers to new jobs — an important objective in a dynamic economy.

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[49] Ibid., p. 77.

The government, in consultation with the provinces, also made several changes to the Canada Pension Plan to increase disability benefits, tighten regulations for the sharing of benefits on separation or divorce, and increase contribution rates. Other pension changes saw substantial increases in the maximum allowable level of Registered Retirement Savings Plan (RRSP) contributions.

Reforms to benefits and pensions over the past four years have generally raised incomes and reduced poverty among the elderly. The changes have failed, however, to address the original challenge the government set out to tackle in 1984 — a reallocation of elderly benefits to those most in need. High-income retirees have seen their benefits enhanced over the past four years through changes to the RRSP program, while the continuing poverty among women over the age of 65 is testimony to the inadequacies of the system.

Child Care

Although the Conservative party promised a national child-care plan in the 1984 election campaign and made some assurances in the new government's first Throne Speech, child care was not addressed in the *1984 Agenda*. Despite this, it formed a major component of the government's agenda in the second half of its term, culminating in the December 1987 announcement of the National Strategy on Child Care and the tabling, in July 1988, of Bill C-144.

Previous federal participation in child care had been limited to cost sharing in provincial expenditures under the Canada Assistance Plan for low- and middle-income families and tax initiatives for families using child care. Most users perceive the current system to fall well short of meeting the overall demand for the service.

Some Canadians are skeptical of the need for increased government involvement in child care. There are, however, two basic arguments in favor of it.

First, the present system does not satisfy the demands placed on it as a result of social and demographic changes. More women with children choose to work or must work because of economic circumstances — the labor force participation rate of women with children under three years of age increased to 54 percent in 1985 from 31 percent in 1975.[50] In this sense, child-care services can be viewed as critical to the advancement of women in the work force and, by extension, to their employment equality.

Second, longer-term labor supply considerations also underline the importance of investing in the child-care system. By making it easier for women to work outside the home, child-care services increase the size and productivity of the labor force, thus contributing to economic growth now and in the future.

If one accepts that an expansion of child-care services will enhance both equity and economic growth, how much expansion is required and how can the expansion best be achieved?

The approach favored by most women's groups and child-care advocates, and generally supported by the two opposition parties, is to concentrate on the creation and financing of spaces in nonprofit child-care institutions. The various proposals differ in the degree of expansion recommended. Some suggest modest expansions of existing spaces, while others, such as the Cooke Task Force, have argued for free and universally accessible child-care facilities akin to the public school system.[51]

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[50] Statistics Canada, *Women in the Workplace: Selected Data*, Cat. no.71-534 (Ottawa, 1987), Table A-4.

[51] The Cooke Task Force estimated that its proposals would cost roughly $11 billion per year by the time the universal system was operational in the late 1990s (Status of Women Canada, Task Force on Child Care, *Report* [Ottawa: Supply and Services Canada, 1985]).

Another, less direct approach is to maximize child-care options by supporting a broader range of child-care alternatives — that is, both nonprofit and commercial centers — and/or by providing financial assistance for parents to use on whatever child-care option they select, including care at home or by neighbors or relatives.

The National Strategy contains elements of both these approaches. Bill C-144 would earmark almost $4 billion over seven years for sharing in expenditures in operating and capital subsidies to child-care institutions and to low- and middle-income families using child-care services. In addition, the February 1988 budget made available a further $2.3 billion in tax assistance to parents of children under seven years of age, the bulk of which went to enhance the child tax credit and the balance to increase the allowable deduction for receipted child-care expenses. These tax provisions are already in place and do not depend on passage of Bill C-144.

Critics of the proposed legislation argue that the government's overall financial commitment of $6.4 billion over seven years is inadequate to meet the needs of the system. Opponents also object to the generous tax breaks available to child-care users, maintaining that they would do little to increase the number of child-care spaces. Further, Bill C-144 is criticized for its support of provincial contributions to operating expenses incurred by commercial child-care centers and subsidies to families using commercial centers. Many child-care advocates believe that commercial enterprises provide poorer-quality care than do nonprofit centers and, therefore, should not be eligible for public assistance.

The government's approach is a compromise between the demands of those calling for an expanded child-care system and the misgivings of other Canadians who remain uncomfortable with a large scale commitment to child-care expansion. By concentrating some of the assistance in the hands of parents, the government's proposal avoids a commitment to an ambitious target of nonprofit child-care spaces that could act as a floor on which future policy expenditures would be based.

The status of Bill C-144 is still uncertain, thus leaving incomplete an important component of the National Strategy. The bill probably will be reintroduced, possibly in a revised form, early in the government's next term.

It is important that this legislation be passed and the expenditure components of the strategy put in place. Although the government's proposals fall short of the expectations of many child-care users and advocates, they are an improvement over the status quo. By contributing, through the provinces, to operating and capital expenditures, the government has committed itself to the creation and financing of child-care spaces for the first time. Although the National Strategy crawls, rather than walks or runs, to an expanded child-care system, it does at least go in the right direction.

Limited Progress on Social Policy

The government's accomplishments in the reform of social policy were concentrated in the areas of family benefits and child care. In particular, its improvements in the after-tax position of low-income families and in integrating the tax and transfer system for families with children should serve as an example of what could be achieved in other areas of the social policy system.

In spite of progress in some areas, the government has not addressed the most serious flaws in the system. Specific areas of disappointment include the failure to deal with UI reform, with a better targeting of elderly benefits, and with the integration of the tax and transfer systems.

The government's inability so far to deal with social policy reform can be traced to three basic factors.

First, its credibility in the social policy area is hampered by a perception that it is oriented primarily toward "big business", owing to the priority it has attached to trade policy, investment policy, and other areas of economic management. This lack of credibility has affected its willingness either to follow through or to undertake reform, as well as the amount of criticism that its proposals have generated.

Second, the government appears to be considerably more comfortable with business issues, and has exhibited within its own ranks a lack of consensus on the objectives of social policy reform and how best to approach these issues.

Third, social policy is difficult to change because current recipients of the system, future recipients who feel they are owed their due, and provincial governments all are tremendously attached to the status quo.

Part of the government's difficulty is that its initial approach to social policy reform — targeting programs in order to trim government spending — was flawed from the outset. A better approach would have been to view social policy reform as an important way to improve the performance and flexibility of the economy. It is through tackling the many structural problems inherent in the work-welfare system that those caught in the difficult transition between dependence and work can best be helped. In the process, such an approach can contribute to overall efficiency and cost savings.

An Assessment of the Record

The *1984 Agenda* promised to change the federal government's approach to economic policy and to reduce government-imposed impediments to the entrepreneurial process and the operation of markets. It is fair to say that the government made a significant beginning in bringing about the changes it had promised and that the effects on Canada's economy have been positive.

Not surprisingly, the government's record in implementing its agenda is mixed. It achieved significant progress in three areas.

First, with the outcome of the 1988 election, the government received a mandate to proceed with what had become the centerpiece of its program — free trade with the United States. After a relatively short 18 months of negotiations, trade policy experts were genuinely impressed with the scope of the Agreement. Not only did it make progress in eliminating or reducing traditional trade barriers such as tariffs and quotas, it also broke new ground on such issues as standards, dispute settlement, and trade in services that will be a model for other free trade groupings.

Second, the government made significant progress in improving the regulatory framework covering foreign investment, energy, transportation, and financial services. More remains to be done, but the positive effects of what was accomplished are generally underrated.

Third, the successful completion of a 20-year battle to reform Canadian competition policy was a significant achievement.

In several policy areas reviewed in this chapter, the government can claim only modest success. In macroeconomic policy, the key issue was deficit reduction. The government made some progress here, but fell well short of its own modest targets. Although Canada's fiscal situation would be worse without the government's deficit-reduction measures, the federal public debt continues to grow faster than the economy and the country's fiscal room to maneuver in the event of an economic downturn has been completely used up.

The government's accomplishments were also modest in areas such as privatization and science and technology policy. In the former, the government clearly feared adverse public reaction; in the latter, it has begun to form a consensus on the approach to take. Future progress in these areas will depend on Canadians' being convinced of the potential economic benefits of new approaches.

The report card on Stage I of tax reform is mixed. The reform of personal and corporate income taxes did respond successfully to the challenge of U.S. tax reform. But it fell far short of correcting some of the worst flaws of Canada's tax system. While the tax rate reductions and base broadening personal and corporate taxes were a move in the direction of improved fairness and economic efficiency, the decision to break tax reform into two stages — leaving sales tax reform to the next agenda — limited the scope of income tax rate reductions and was probably responsible for the excessively tough treatment of investment income.

In a third group of policy areas, the government's efforts must be judged a failure. The most obvious of these is the lack of reform of unemployment insurance, which every commission or study team that has examined the program has recommended. The second is the failure to bring forward a concrete sales tax reform proposal. If the government successfully accomplishes Stage II of tax reform in its second term, history may judge that it made a wise choice to defer the issue in 1987. It is fair to say, however, that given the public attitude toward sales tax reform demonstrated in the 1988 election campaign, the government has made the task of completing tax reform more difficult.

Two concluding observations are in order. Although the government won a major battle on free trade, the other areas where it achieved significant progress were those in which there was little organized public resistance to change. It made far less progress in areas — such as deficit reduction, UI reform, sales tax reform, and social policy reform — where it had to convince Canadians of the economic benefits of its proposed actions. In these areas, the government clearly lacked not only the ability to explain its objectives in a way that a majority of Canadians would accept but also the political will to see its proposals through.

Finally, while the Conservative government's economic policy accomplishments have been relatively impressive, much remains to be done. Chapter 4 provides an assessment of the priorities of the next agenda. But first, it is important to consider the broader changes under way in the world economy that are shaping the Institute's view of Canada's economic priorities.

PART II

Looking Ahead

3

Forces of Change in the World Economy

Powerful forces are changing the world economy in ways that will profoundly affect Canada in the 1990s and beyond. This is not a new phenomenon. Rapid economic, technological, and social change has become the norm as global integration has proceeded in recent decades. But the fact that pervasive change is not new makes it no less important for Canadians to understand and anticipate it.

Canadians have not always responded well to global economic change, preferring instead to use their country's substantial wealth — built up for over a century by exploiting abundant natural resources — to shield themselves from global shocks. Examples of this reluctance to adapt include the holding of domestic energy prices below world price levels from the mid-1970s to the mid-1980s; government bailouts, buyouts, and subsidies to firms in declining industries; the continuing propensity to underwrite uneconomic megaprojects in the name of regional economic development; and the failure to rein in government expenditure, deficits, and debt, even when the economy is growing robustly.

Canada's postwar economic record clearly indicates that temporizing and failing to respond to new global realities has proven costly to living standards in the short term and unsustainable in the longer term. In recent years, however, the design of Canadian economic policy has demonstrated a welcome shift toward anticipating and adjusting to economic change. The record is by no means uniform, but policy has shifted in many areas toward a more outward-looking stance that sees global change not only as inevitable, but as an opportunity rather than a threat. It is important that this shift continue and accelerate in the years ahead.

Four major types of change will be important in the 1990s in shaping the policies of the next agenda: environmental, technological, and demographic, and changes in the world economic order. The interrelationship among the four types of change requires a discussion of each.

Environmental Change

In April 1987, the World Commission on Environment and Development — an international panel chaired by Norwegian Prime Minister Gro Harlem Brundtland — published a chilling analysis of environmental trends that threaten to alter the planet radically:

> Each year another 6 million hectares of productive dryland turns into worthless desert.....More than 11 million hectares of forests are destroyed yearly...Much of this forest is converted to low-grade farmland unable to support the farmers who settle it...Acid precipitation kills forests and lakes and damages the artistic and architectural heritage of nations...The burning of fossil fuels puts into the atmosphere carbon dioxide, which is causing gradual global warming. This 'greenhouse effect' may by early next century have increased average global temperatures by enough to shift agricultural production areas, raise sea levels to flood coastal cities, and disrupt national economies. Other industrial gases threaten to deplete the planet's protective ozone shield to such an extent that the number of human and animal cancers would rise sharply and the ocean's food chain would be disrupted. Industry and agriculture put toxic substances

into the human food chain and into underground water tables beyond reach of cleansing.[1]

While the scientific community continues to debate the implications of these trends, the evidence led the Commission to serve notice that the time has come to take decisive action, both domestically and through international institutions, to encourage "sustainable development." This comes from a growing recognition that it is difficult to separate economic from environmental issues. Global poverty, for example, is both a major cause and effect of global environmental problems. Economic development continues to be essential, but, to avoid environmental calamity, future development can no longer be allowed to erode the environmental resources on which it must be based.

Since the release of the Brundtland Report, environmental concerns — particularly those relating to the "greenhouse effect", ozone depletion, and toxic waste — have increased. In the years ahead, there will be increasing focus on the interdependence of environment and the economy. For Canada, this means greater integration of environmental considerations into private- and public-sector decisionmaking. It means creating appropriate incentives to halt and reverse environmental damage caused by acid rain and toxic waste. It means contributing to global environmental protection by taking a leadership role in international councils dealing with environmental issues and by ensuring that Canadian assistance to developing countries supports only projects that meet the test of environmental soundness.

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[1] World Commission on Environment and Development, *Our Common Future, Report to the United Nations General Assembly* (Oxford: Oxford University Press, 1987), pp. 2–3.

Technological Change

Science historians estimate that scientific knowledge doubles every 15 years. With this comes a heightened awareness of the rapid pace of scientific and technological advances.

The current generation of new technologies is inexorably restructuring and reshaping the world economy. Key technologies in which advances currently are under way include:

- microelectronics, which is reshaping computing, communications, and manufacturing design and processes;
- biotechnology, which has important applications in medicine and in developing new plant and animal strains;
- laser optics, with applications in aerial surveillance, welding, surgery, printing, and fiber-optic communications;
- the material sciences, where advances in ceramics, polymers, and composite materials are improving the quality and durability of many products; and
- superconductivity, which holds the long-term promise of diverse applications in ultrahigh-speed computer chips, medical diagnostics, and highly efficient power transmission.

These new technologies have the power to transform production processes as well as final products. In so doing, they dramatically reduce costs and increase quality in existing industries and, at the same time, create whole new industries.

Canadian industries are already participating actively in the application and refinement of these new technologies. Some people worry that Canada's role in developing new technologies is too small and that more resources should be channeled to high-technology industries. The greater challenge, however, is to adopt new technologies to Canadian needs in ways that enhance competitiveness and encourage adjustment to a constantly changing industrial structure.

Demographic Change

The world's population now exceeds five billion and continues to increase, although at a decelerating rate. It will exceed six billion by the year 2000 and is expected to stabilize between 8 and 14 billion sometime in the next century. More than 90 percent of the increase will occur in the developing countries.

The continuing pressure of population growth increases the demand for food and other basic necessities of life and puts increasing strain on urban agglomerations, particularly in the developing countries. In light of these trends, tensions between rich and poor countries will continue. Pressures for more open immigration policies in less heavily populated countries can be expected to intensify.

In the industrial economies, populations are stabilizing as birth rates decline. After growing at an average annual rate of 1.1 percent during the 1950–80 period, the populations of the OECD (Organisation for Economic Co-operation and Development) countries are expected to grow by only 0.3 percent annually between 1980 and 2010. After 2020, populations are expected to decline in most industrial countries.

At the same time, these populations are aging, a trend accentuated by the postwar "baby boom". The main cause of this aging is the steady decline in fertility rates. In most industrial countries, fertility rates increased from the mid-1940s until the mid-1960s and then began to decline. Trends in life expectancy and migration have also contributed to population aging, but their impact has generally been less than that of changes in birth rates.

In the OECD countries, the elderly are expected to increase from 91 million in 1980 to 116 million by 2000 and to 131 million by 2010.[2] This represents an increase to 15.3 per-

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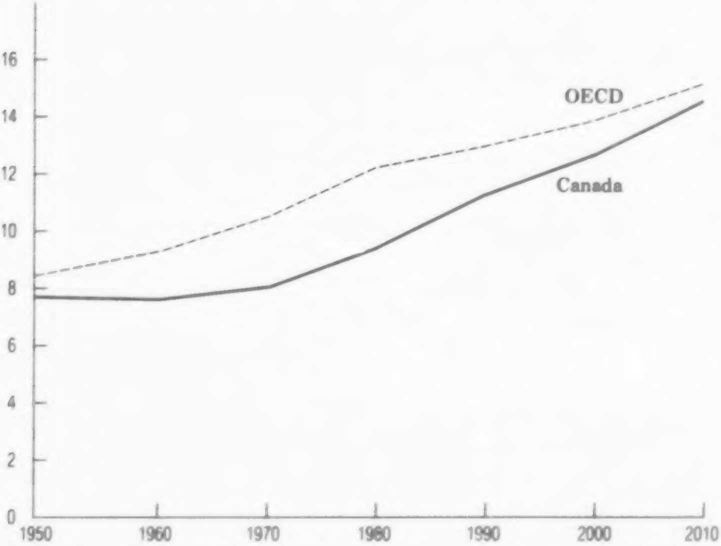
[2] Organisation for Economic Co-operation and Development, *Ageing Populations: The Social Policy Implications* (Paris, 1988).

Figure 6
Elderly Population in Canada and All OECD Countries, 1950–2010
(percentage of population aged 65 and over)



Source: Organisation for Economic Co-operation and Development, *Ageing Populations: The Social Policy Implications* (Paris, 1988).

cent of the population in 2010 from 12.2 percent in 1980, as shown in Figure 6. Canada's population will age relatively rapidly compared with other industrial countries, with the elderly increasing to 14.6 percent of the population in 2010 from 9.5 percent in 1980. Furthermore, the age of the elderly population is expected to increase, with those over 80 rising to 25 percent of the elderly in 2010 from 19 percent in 1980.

Key concerns arising from these demographic trends are whether aging populations will lead to major increases in the cost of social programs, such as pensions and health care, that cater to the elderly and whether society will be able or willing to cover the additional cost.

Table 9
Growth of Real Social Expenditures Implied by Projected Demographic Change, 1980–2010
(1980 = 100)

	Education	Family Benefits	Health	Unemployment	Pensions	*Total*
Rapidly Aging[a]						
Japan	87	86	145	103	219	*141*
Canada	92	94	159	130	196	*141*
West Germany	63	66	104	92	126	*104*
Medium Aging[b]						
Australia	113	109	162	131	176	*146*
France	84	84	115	112	140	*116*
Netherlands	82	80	121	111	140	*115*
Italy	71	69	114	101	126	*108*
Slowly Aging[c]						
United States	98	105	131	126	144	*125*
Sweden	85	85	104	101	111	*101*
United Kingdom	91	95	104	105	107	*101*
Belgium	78	80	103	99	112	*98*

[a] Proportion of population aged 65+ projected to rise more than four percentage points.

[b] Proportion of population aged 65+ projected to rise two to four percentage points.

[c] Proportion of population aged 65+ projected to rise less than two percentage points.

Source: Organisation for Economic Co-operation and Development, *Ageing Populations: The Social Policy Implications* (Paris, 1988), Annex B, Table B.1, pp. 86–89.

The OECD has projected social program spending based on existing per capita expenditures by age group, assuming that program coverage and real per capita social benefits remain unchanged. (This isolates the impact of demographic changes from other factors that influence social expenditures.) Table 9 presents the growth of social spending related to projected demographic changes in several OECD countries over the 1980–2010 period. The table shows that population aging will affect these countries in a broadly similar fashion, but with some important differences.

The main similarities are that the rising proportion of older people will tend to increase social spending on health and pensions by more than it reduces spending on education and family benefits. The differences relate to the speed at which various countries' populations are aging and to the maturity of their pension systems. Those countries with populations that are aging faster will experience faster growth of overall social spending, driven largely by age-related increases in health and pension spending. In countries such as Japan and Canada, the combination of relatively rapid aging and rising real pension benefits as pension systems mature means that social expenditures are expected approximately to double in real terms, even if real per capita benefits for fully eligible individuals remain constant at their 1980 levels. It is possible, of course, that rapidly aging societies will respond to spending pressures by increasing the retirement age or the inflow of younger immigrants.

Sociodemographic change, therefore, is likely to pose significant economic challenges in the years ahead. Population growth in the developing countries will increase the need for more efficient and environmentally sound utilization of the world's resources. It will also increase pressures on industrial countries to accept more immigrants. For the industrial countries themselves, population aging will be an important source of pressure on social spending.

Changes in the World Economic Order

Economic change is a pervasive feature of the global economy. Some commentators see the changes taking place as ominous and as leading inevitably to crisis; others see them as signs of continuing dynamism in an increasingly complex and interrelated world economic order.

Globalization

Originally defined by Professor Theodore Levitt of the Harvard Business School, "globalization" refers to the emergence of global markets for standardized consumer products.[3] Levitt notes that many multinational companies are abandoning the notion of differences in national or regional preferences. By treating the world as a single market for the product, companies can benefit from enormous economies of scale in production, distribution, marketing, and management.

Driving the trend toward globalization of markets is the development of worldwide communication networks. Some people speak of the "globalization of everything," but the trend is particularly evident in financial markets. These markets operate electronically, virtually 24 hours a day. In terms of the dollar volume of transactions, international flows of capital are now far larger than are international trade flows. Furthermore, as became evident in October 1987, disturbances in financial markets are quickly transmitted around the globe.

Equally significant is the tendency toward globalization of some manufacturing industries. Encouraged by the growing scale of world markets and the uncertainties associated with large swings in currency values, global corporations increasingly are setting up manufacturing locations in the main market areas: the United States, Europe, and Asia. As Peter Ludlow, of the Centre for European Policy Studies, points out:

> The capacity of major companies to shift complex production operations from one side of the globe to another in a matter of weeks rather than months, the impact of investment decisions taken in one country upon output in another, and the growing significance of intrafirm trade...all highlight the increasingly obsolete character of the traditional concept of a national corporation.[4]

Indeed, the new global corporation is not the same as the old multinational. The multinational operates in a number of countries and adjusts its products and practices to local conditions in each — at relatively high costs. The new global corporation operates with resolute constancy — at low relative cost — as if the entire world (or major regions of it) were a single entity.[5]

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[3] Theodore Levitt, "The Globalization of Markets," *Harvard Business Review,* May-June 1983, pp. 92–102.

[4] Peter Ludlow, "Dealing with Disarray," *Policy Options,* July 1988, p. 26.

Globalization is a reality that all countries must deal with. It is driven by the contest among firms for markets and the lowest possible costs of production and distribution. It forces each country to examine its business climate in comparison with other countries competing for new investment. This climate is defined by such factors as access to world markets, taxation, availability of a skilled and educated work force, and, above all, political and economic stability. Countries that choose to swim against this powerful tide risk losing investment and seeing their relative living standards flounder.

Shifts in World GNP

For close to two decades, economic historians and world leaders have recognized the emergence of a multipolar international economic order. In 1971, U.S. President Richard Nixon pointed to the existence of five clusters of world economic power — Western Europe, Japan, China, and the two superpowers, the Soviet Union and the United States: "These are the five that will determine the economic future, and because economic power will be the key to other kinds of power, the future of the world in other ways in the last third of this century."[6]

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[5] Ibid., pp. 92–93. For further discussion, see William J. Beeman and Isaiah Frank, *The New Dynamics in the Global Economy* (New York: Committee for Economic Development, 1988), pp. 3–12.

[6] Quoted in Paul Kennedy, *The Rise and Fall of the Great Powers* (London: Unwin Hyman, 1988), p. 413.

Table 10
Distribution of World Gross National Product, 1960–2000

	1960	**1980**	**2000**
Industrial countries	*62%*	*62%*	*56%*
United States	33	22	20
European Community	18	22	18
Japan	3	9	10
Other	8	9	8
Developing countries	*14*	*16*	*17*
Newly industrializing countries[a]	3	5	7
Other	11	11	10
Socialist countries	*24*	*22*	*27*
Soviet Union	15	13	12
China	5	5	11
Other	4	5	4
Total	*100*	*100*	*100*

[a] Brazil, Hong Kong, Mexico, Singapore, South Korea, and Taiwan.

Sources: C.D. Howe Institute, based on data obtained from Economic Planning Agency, *Japan in the Year 2000* (Tokyo: Japan Times, 1983), p. 40; World Bank, *World Development Report 1988* (Washington, D.C.: Oxford University Press for the World Bank, 1988), pp. 224–225; General Agreement on Tariffs and Trade, *International Trade 1986–87* (Geneva: GATT, 1987), p. 181; Organisation for Economic Co-operation and Development, *OECD Economic Outlook*, June 1988, p. 170.

The 1980s have witnessed a continuation of the trend toward a more even distribution of global economic power, as shown in Table 10.

The United States' share of world GNP, which had temporarily reached almost 40 percent following the Second World War, declined to 22 percent in 1980 from 33 percent in 1960. This is a relative, not an absolute, decline. The United States remains the largest economic power on earth, with the highest GNP per capita among the major industrial countries. Yet, it is now being challenged by other economies, some having rebuilt after wartime destruction and others having taken off into sustained economic growth.

Japan demonstrated the fastest economic growth during the 1960–80 period, establishing itself as a global economic powerhouse with 9 percent of world GNP at the end of the period, up from 3 percent at the start. Europe also increased its share of world GNP as war-devastated countries, particularly West Germany, enjoyed a period of reindustrialization and rapid economic growth. The formation of the European Economic Community with the signing of the Treaty of Rome in 1960 contributed to this strong economic performance by reducing barriers to trade and labor mobility.

The developing countries made a small gain in their share of world GNP during the 1960–80 period, but this was concentrated in six so-called newly industrializing countries (NICs): South Korea, Hong Kong, Singapore, Taiwan, Brazil, and Mexico. The rest of the less-developed countries just maintained their 11 percent share of world GNP, although their share of world population increased to 75 percent in 1980 from 69 percent in 1960.

In the 20 years to 1980, the centrally planned economies experienced a small decline in their share of world GNP. The Soviet Union's real GNP grew at a slightly slower rate than that of the industrialized countries. China's GNP grew faster, but the disruptions associated with the Cultural Revolution continued to hold that country back.

By the year 2000, the dispersion of world economic power will have proceeded further. The United States and the European Community will account for about 20 percent and 18 percent, respectively, of world GNP, a further reduction of their 1980 shares. The Soviet Union's share, even in the event that *perestroika* succeeds, also will likely decline, to 12 percent of world GNP from 13 percent in 1980. The two Asian powers, however, will continue to increase their shares. China, which has demonstrated explosive real GNP growth in excess of 10 percent annually in the 1980s, is likely to narrow greatly the gap with the Soviet Union, increasing its share to 11 percent of world GNP. Indeed, China likely will surpass the Soviet Union as the world's second-largest national economy in the first quarter of the twenty-first century. Japan could also surpass the Soviet Union as it moves above 10 percent of world GNP by 2000.

Thus, the world economy of 2000 is likely to be characterized by five more evenly balanced concentrations of economic power than have existed at any time in the postwar era. Countries that maintain their share of world trade and output over the next decade or so will be those that are able to compete effectively, not only in the high-income markets of the industrialized countries but also in the fast-growing economies such as China and the NICs.

The Trend toward Regional Blocs

A third major force of change in the global economy is the emergence over the past 25 years of regional trade blocs.

The most advanced example of a regional grouping is the European Community (EC), formed in 1957. The formation of the EC triggered the creation of the European Free Trade Association (EFTA), which comprised countries that wanted the benefits of free trade without having to accept common industrial or agricultural policies or, more importantly, the objective of eventual political integration.

The EC has grown from six members with a population of 165 million in 1960 to 12 members with a population of 320 million in 1988. The combined GNP of EC members is roughly equal to that of the United States; its production of automobiles, steel, and cement is larger than that of the United States, Japan, and (except in steel) the Soviet Union.[7] Furthermore, the EC has individual free trade agreements with each of the members of EFTA, which extends its tariff-free access to a market of another 40 million people.

In Asia, closer economic integration is occurring on a less formal basis. Japan is the dominant economy of the region, and its trade and investment with other Asian countries has been a driving force of increased integration. Japan, the Association of South-East Asian Nations, and the Asian NICs of South Korea, Hong Kong, and Taiwan increasingly are engaged in economic cooperation involving some liberalization of trade and investment flows within the region.[8]

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[7] Ibid., p. 472.

In North America, the United States and Canada have entered into a comprehensive free trade area agreement. The United States and Mexico have also agreed to a more modest, but still significant, reduction of bilateral trade barriers.

Finally, a group of centrally planned economies, including the Soviet Union, other members of the Council of Mutual Economic Assistance — also referred to as COMECON — and China comprises another significant trade bloc.

Table 11 is a matrix of world trade showing the origin and destination of exports from the major trading areas for the years 1970 and 1986 as a percentage of total world exports. While the data in the table represent world export market shares, it is important to note that the value of world exports increased sevenfold over the period and the volume more than tripled. Along the diagonal of the matrix, trade within the major areas is shown as a percentage of total world exports. Off the diagonal, trade between the major blocs is shown.

Several trends can be discerned from the table. First, the sum of the figures on the diagonal demonstrates that trade within the major groups increased to almost 48 percent of total world trade in 1986 from 45 percent in 1970.

Second, the Asia-Pacific region has been the most dynamic in terms of export growth. Its exports as a percentage of total world trade have increased in every major regional market; there has been a substantial increase in trade within the Asia-Pacific region; and the region has developed a large trade

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[8] For an excellent discussion of economic cooperation within the Asia-Pacific region, see Lydia Dunn et al., *In the Kingdom of the Blind: A Report on Protectionism and the Asian-Pacific Region* (London: Trade Policy Research Centre, 1983), pp. 85–107.

Table 11

Trade among Regional Blocs, 1970 and 1986

(percentage of world exports)

Origin of Exports		Destination of Exports Canada/ U.S.	Asia-Pacific	EC/EFTA	East Bloc	Other	*Total*
Canada/U.S.	1970	6.2	3.1	4.7	0.2	4.5	*18.7*
	1986	5.1	2.6	2.6	0.4	3.0	*13.7*
Asia Pacific	1970	3.3	3.2	1.5	0.6	2.1	*10.7*
	1986	7.1	5.1	2.7	1.3	2.8	*19.0*
EC/EFTA	1970	4.0	1.6	24.1	1.8	11.9	*43.4*
	1986	4.5	2.1	25.6	1.7	9.7	*43.5*
East Bloc	1970	0.1	0.6	1.3	6.3	2.2	*10.5*
	1986	0.3	1.1	1.5	7.0	1.9	*10.8*
Other	1970	3.3	2.5	10.4	1.5	5.3	*23.0*
	1986	3.2	2.7	7.2	1.4	4.8	*19.3*
Total	*1970*[a]	*16.4*	*10.8*	*37.6*	*10.0*	*25.2*	*100.0*
	1986[b]	*19.6*	*13.3*	*35.2*	*10.4*	*21.5*	*100.0*

[a] Total world exports in 1970 were U.S.$313 billion.

[b] Total world exports in 1986 were U.S.$2,119 billion.

Source: General Agreement on Tariffs and Trade, *International Trade 1986-87* (Geneva, 1987), pp. 177-178.

surplus — equal to about six percent of total world exports — with the rest of the world.

Third, North America has experienced the largest relative decline in the share of world exports — five percentage points from 1970 to 1986. Its exports as a percentage of world trade have declined in every major region; bilateral Canada-U.S. trade has declined as a proportion of world trade; and the region has developed a trade balance of equal but opposite magnitude to that of the Asia-Pacific region — a deficit equal to six percent of total world exports.

Fourth, the trends indicate that Western Europe — represented by the combined membership of the EC and EFTA in 1986 — has become more inward looking. The relative increase of intraregional trade within Europe has been just sufficient to offset the relative decline of its trade with the rest of the world.

Fifth, the countries that do not fall within the main groupings have experienced a sharp decline of almost four percentage points in their share of world exports since 1970. The stagnation of exports from these countries — which are found largely in the Middle East, Africa, and Latin America — is attributable in varying degrees to weak commodity prices, problems associated with their heavy indebtedness, protectionism practiced by the large trading blocs, and poor economic management within some of the developing countries.

The main significance of the regional economic blocs is that trade is being liberalized inside the blocs, while trade among the blocs is subject to increasing frictions, which in part reflect the increased importance of trade to all countries.

Freer trade within the regions is a mixed blessing. By leading to rationalization of production and strong economic growth within regions, it creates some trade. But there is also trade diversion. Canada certainly experienced trade diversion when the United Kingdom joined the EC. The United Kingdom switched its purchases of some goods that were produced more efficiently in Canada — agricultural products, for example — to other EC members.[9] No new trade was created in this case; it was merely shifted to a less efficient producer. As the process of European integration has proceeded, as is clear from Table 10, trade within the region has increased relative to total world trade, while Europe's trade with the rest of the world has declined in relative terms.

Regional integration can be part of an outward-looking trade strategy, however, as the experience of the Asia-Pacific region demonstrates. While trade within the region has grown in importance, imports from the rest of the world have also increased in relative importance.

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[9] Bertrand Nadeau, *Britain's Entry into the European Economic Community and its Effects on Canada's Agricultural Exports* (Ottawa: Institute for Research on Public Policy, 1985).

One key question about regional groupings is whether they promote or undermine the multilateral trade system administered by the General Agreement on Tariffs and Trade (GATT). Advocates of the Canada-U.S. Free Trade Agreement have argued that it will promote free multilateral trade by meeting GATT rules, which require such agreements to cover virtually all trade; by breaking new ground in covering services, energy, and agriculture; and by refraining from raising trade barriers against the rest of the world.

Europe's program of integration, on the other hand, which aims to create a single European market without trade barriers of any kind by 1992, has raised concerns in the rest of the world that what Europe wants is a big, sheltered market for European companies. It is widely assumed that, after 1992, access to the European market for non-European firms will have to be paid for by offers of increased access for European firms in foreign markets. As *The Economist* recently pointed out, "the unhappy paradox is that project 1992 is, in European terms, a grand gesture of deregulation and economic liberalism, while to the world outside it appears a fortress blocking the way towards improvements in the rules of world trade."[10]

For a medium-sized economy such as Canada, the trend toward regional blocs carries with it both significant opportunities and worrisome threats. If regional trade liberalization can be carried out within GATT rules, then it may well be a source of trade creation and may increase progress toward multilateral free trade. If regional groupings incite new frictions and trade barriers among groups, the risks become significant, especially for countries that do not have access to a large, secure market through a regional grouping. Such countries increasingly would be caught in the protectionist crossfire between the main trading blocs.

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[10] "The Shape of Europe's Trade," *The Economist*, September 3, 1988, p. 14.

The Rapid Growth of Debt

The 1980s have seen an explosion of debt, public and private, domestic and foreign. Three types of debt problems are of particular interest: developing-country debt, public-sector debt in the industrial countries, and total debt in industrial countries.

Developing-Country Debt

The crisis of developing-country debt erupted in 1982. Its effects are reflected in Table 12, which shows debt-to-GNP and debt-service ratios for the developing countries. At the end of 1987, their total external debt was U.S.$1.22 trillion, up from U.S.$636 billion at the end of 1980.[11]

The burden of this debt is best gauged by expressing both the level and the cost of servicing — that is, paying interest on — the debt as a percentage of the developing countries' GNP. The value of their external debt relative to GNP increased by 139 percent over the 1975–87 period. Debt service became particularly onerous in 1982, when U.S. interest rates exceeded 20 percent. Brazil and Mexico, the two most heavily indebted countries in Latin America, were overwhelmed by debt-service costs and were unable to service their debts on time. At that time, major U.S. banks had loans to developing countries amounting to almost 200 percent of their bank capital.[12] Defaults by major countries could have wiped out the capital of these large banks, thereby posing enormous risks to the entire world financial system. Crisis was avoided by a rescue mission organized by the International Monetary Fund, which averted a Mexican default.

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[11] International Monetary Fund, *World Economic Outlook*, October 1988, p. 15.

[12] "LDC Debt Realities," *World Financial Markets* (Morgan Guaranty Trust Company of New York), June-July 1987, p. 3.

Table 12
Debt Indicators of Developing Countries, 1975–87

	All Developing Countries		Highly Indebted Developing Countries		Low-Income African Developing Countries	
	Debt Service Ratio[a]	Debt/GNP Ratio	Debt Service Ratio	Debt/GNP Ratio	Debt Service Ratio	Debt/GNP Ratio
1975	13.7	15.7	24.0	18.1	10.2	25.2
1980	16.2	20.7	27.1	23.3	13.6	39.8
1981	17.9	22.4	30.7	25.6	14.6	44.2
1982	21.0	26.3	38.8	32.4	14.2	48.0
1983	19.7	31.4	34.7	45.4	14.2	55.1
1984	19.5	33.0	33.4	47.5	15.1	62.0
1985	21.8	35.9	33.9	49.5	17.9	68.9
1986	22.6	38.5	37.7	54.1	19.9	72.1
1987	21.0	37.6	32.7	55.9	34.7[b]	76.2

[a] The value of external debt payments as a percentage of the value of exports of goods and services.

[b] The buildup of arrears accounts for this sharp increase in 1987.

Source: World Bank, *World Development Report 1988* (Washington, D.C.: Oxford University Press for the World Bank, 1988), p. 31.

The exposure of large U.S. banks to developing-country debtors has declined markedly since 1982, but remains near 100 percent of bank capital. Some countries, such as Mexico, Brazil, Argentina, and Chile, have been able to reduce their debt-service burden, partly through the pursuit of export-led growth, but also, and more importantly, through the general decline in interest rates.

Nevertheless, the situation in some debtor countries remains desperate — in some cases worse than it was in 1982. As Table 12 shows, debt-service ratios have remained high in the highly indebted countries and have worsened dramatically in low-income African countries. As Jeffrey Sachs, noted Harvard economist and a consultant to the World Bank, has said:

> The debtor countries were squeezing enormously and willingly paying their debts, but their economies were crumbling. The U.S. administration and the U.S. press viewed the problem as essentially a banking crisis. They rejoiced in the 'great progress we've made.' Few people understood, and

> certainly the larger public was unaware, that you can't make fundamental progress in this kind of crisis unless the debtor countries get better as well.[13]

This growing recognition led, in 1988, to several proposals for selective debt forgiveness. For example, the United Nations Committee on Trade and Development, the International Monetary Fund, and the American Express Bank each put forward proposals for repurchasing developing-country debt, particularly to give relief to the low-income African debtor countries. A sizable group of economists believes that only by reducing their debt burden will these countries be given an opportunity to restore economic stability and to encourage investment and growth.

For other highly indebted countries, however, debt forgiveness is not the answer. In the middle-income developing countries, more emphasis is needed on domestic policy reforms. Without better monetary, fiscal, trade, and industrial policies, there is little prospect of resolution of these countries' economic and debt problems.

Public-Sector Debt in the Industrial Countries

Developing-country debt, serious as it is, is not the only debt problem facing the world economy. The industrial countries, too, have run up substantial public- and private-sector debt levels in the 1980s. In particular, much attention has focused on the rapid growth of public-sector debt, as shown in Table 13. After rising only marginally from 1972 to 1980, the public debt-to-GNP ratio for all OECD countries almost doubled between 1980 and 1988. Canada's ratio tripled. In the process, increasing public-sector debt-service costs have made it difficult for many countries to reduce their budget deficits. Many OECD governments have increased

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[13] Jeffrey D. Sachs, "The Debt Crisis at a Turning Point," *Challenge*, May-June 1988, p. 19.

Table 13
Net Public Debt-to-GNP Ratios of Industrial Countries, 1972–88

	1972	1980	1988
United States	25.7	19.6	30.6
Japan	-6.5	17.2	25.9
West Germany	-5.8	14.3	24.1
France	9.1	9.1	22.0
United Kingdom	64.8	48.2	45.5
Italy	50.0	60.0	109.5
Canada	4.3	13.3	39.0
Other OECD	14.1	19.6	40.0
Total OECD	*18.5*	*21.6*	*39.1*

Sources: Organisation for Economic Co-operation and Development, *OECD Economic Outlook*, June 1987, p. 20; Jean-Claude Chouraqui, Brian Jones, and Robert Bruce Montador, "Public Debt in a Medium-Term Perspective," *OECD Economic Studies* 7 (Autumn 1986): 109.

their indebtedness to the point where their budget positions have become vulnerable to upward movements in interest rates. A few countries, such as the United Kingdom and Australia, have succeeded in reducing their indebtedness, showing that it can be done.

Total Debt in the Industrial Countries

Private-sector debt has also been on the rise in the industrial countries. A 1986 study published by the Bank for International Settlements (BIS) focused attention on the increase in total debt, which underscored concerns that had been expressed by Paul Volcker, former Chairman of the U.S. Federal Reserve Board, and Henry Kaufman, former Chief Economist of Solomon Brothers, Inc.[14]

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[14] E.P. Davis, *Rising Sectoral Debt/Income Ratios: A Cause for Concern?*, BIS Economic Papers 20 (Basle: Bank for International Settlements, June 1987). See also Henry Kaufman, "Debt: The Threat to Economic and Financial Stability," in Federal Reserve Bank of Kansas City, *Debt, Financial Stability and Public Policy* (Kansas City, 1986); and Paul A. Volcker, "The Rapid Growth of Debt in the United States," *Federal Reserve Bank of Kansas City Review* 71 (1986): 3–12.

The BIS study points out that in five large economies — the United States, Japan, West Germany, the United Kingdom, and Canada — the ratio of total debt to GNP rose substantially during the 1975–85 period. In particular, the study notes the rapid growth of personal debt in relation to GNP in the United Kingdom and the United States, growing corporate debt in the United States, Japan, and West Germany, and growing public-sector debt in each country except the United Kingdom. After years of stability at around 1.5 times GNP, total debt in the five countries increased to 1.9 times GNP by 1985 and has continued to rise since.

Several reasons seem to be behind the growth of total debt in the industrial countries:[15]

- inflation in the late 1970s and early 1980s encouraged the growth of debt as borrowers expected the value of their debt to be eroded by inflation;
- new credit instruments have been developed, including junk bonds, floating-rate loans, variable-rate mortgages, indexed bonds, and money market mutual funds, to name a few;
- deregulation of financial institutions has played a role by removing many lending restrictions and interest-rate ceilings; and
- floating-rate financing has greatly reduced interest-rate risks facing financial institutions. Such "spread banking" allows banks to pass on increases in their cost of funds to borrowers quickly.

These are not sinister forces at work. They are systemic changes, driven by competition in the market for financial services, that generally increase the availability and lower the cost of credit. The key question is: Do the increases in debt that such changes make possible increase the vulnerability of the domestic and global economies to a dangerous level?

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[15] See Henry Kaufman, *Interest Rates, Markets and the New Financial World* (New York: Times Books, 1986), pp. 34–61.

In a global context, the growth of debt in virtually all countries and all sectors over the past decade has increased the sensitivity of the world economy to higher interest rates. A sharp rise in rates would again risk overwhelming not only highly indebted developing countries but also spendthrift governments and overborrowed businesses and consumers.

For Canada, the growth of debt poses many concerns. The large Canadian banks, like their U.S. counterparts, have reduced their exposure to heavily indebted developing countries since 1982. They have increased their exposure in other areas, however, including leveraged buyouts, and continue to be vulnerable to adverse developments in interest rates. Canada's public-sector debt has grown faster in the 1980s than that of any other major industrial country except Italy. Canadian governments now have no room to maneuver in the event of an economic slowdown. Canada's corporate-sector debt, though it has improved significantly since the 1981–82 recession, is nevertheless high relative to the 1960s and 1970s.

In the world of the 1990s, those countries best able to cope with turbulence in the world economy and in financial markets will be those that have strong national balance sheets. Canada does not qualify.

Lower Tax Rates

A final powerful trend facing all countries is the recent but widespread move to reduce tax rates and broaden tax bases. This trend began with the U.S. tax reform of 1986, which lowered taxes in that country to rates not seen since the 1920s.[16]

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[16] See Joseph A. Pechman, "Introduction," in Joseph A. Pechman, ed., *World Tax Reform: A Progress Report*, Brookings Dialogues on Public Policy (Washington, D.C.: Brookings Institution, 1988), pp. 1–14.

Table 14
Trends in Marginal Tax Rates, Selected Countries, 1984–88

	Top Personal Rate		**Corporate Rate**	
	1984	**1988**	**1984**	**1988**
United States	55%	33%	51%	39%
Japan	70	50	53	52
West Germany	56	53	56	56
France	65	50	50	42
United Kingdom	60	40	45	35
Italy	65	60	36	46
Canada	51	46[a]	52	44
Australia	60	49	46	49
Netherlands	72	70	43	42
Sweden	82	60	52	52
Denmark	73	68	40	50

[a] Combined federal and provincial rate in Ontario.

Sources: Joseph A. Pechman, "Introduction" *World Tax Reform: A Progress Report* (Washington, D.C.: Brookings Institution, 1988), pp. 4–5; "Britain's Budget Options," *The Economist*, February 20, 1988, p. 68.

Other industrialized countries have been quick to follow the U.S. lead, as shown in Table 14. While the U.S. reductions in both the top personal tax rate and the corporate tax rate are by far the largest (22 and 12 percentage points respectively), other countries, such as the United Kingdom, France, and Canada, also have achieved significant rate cuts. Japan, Sweden, and Australia have managed significant cuts in personal tax rates.

Richard Goode, a tax specialist at the Brookings Institution, offers four reasons why countries have moved to cut rates and broaden bases.[17] First, political developments in several countries led to the election of conservative governments that brought with them diminished support for income redistribution, increased emphasis on markets, and a desire for deregulation. Second, inflation in the 1970s and early 1980s had increased effective tax rates in most countries. Third, there was increased concern in many countries about the adverse effect of high marginal tax rates on economic incentives to work. Fourth, there was a real desire in many countries to simplify tax systems that had become overly complex from years of tinkering by governments' trying to achieve a wide variety of economic and social objectives.

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[17] Richard Goode, "Overview," in Ibid., pp. 269–275.

Another factor, which Goode omits, may have been the most important. Once the United States moved to slash its marginal tax rates, other countries felt compelled to move, for two reasons. First, their failure also to cut rates would have left them with a tax disadvantage large enough to shift new investment and the best and brightest individuals to the United States. Second, there was reason to be concerned that tax planning techniques would allow global corporations to shift taxable income to the United States (where rates are low) and business expenses to other countries (where they would generate larger deductions under the status quo).[18] The result would have been a significant shift in corporate tax revenues to the U.S. Treasury and away from those countries that did not respond with lower rates of their own.

This is yet another indication of the competitive nature of the global economy. Countries cannot allow their tax (and other industrial) policy systems to get too far out of line with the practices of their major competitors if they wish to maintain their share of world investment, economic activity, and tax revenues.[19]

The desire for lower marginal tax rates has made tax-base broadening essential. Most of the major industrial countries have budget deficits that are uncomfortably large. This means that revenues lost through tax-rate cuts must be recouped by cutting back on the myriad tax exemptions, deductions, and preferences that have eroded national tax bases over the years.

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[18] For a discussion of this point, see David Y. Timbrell, "Tax Reform: Effects on Canada's Tax Competitiveness with the United States," in Edward A. Carmichael, ed., *Tax Reform: Perspectives on the White Paper*, Policy Study 4 (Toronto: C.D. Howe Institute, 1988), pp. 63–64.

[19] A decline in tax competitiveness can be offset by allowing the exchange rate to depreciate, but this lowers living standards by raising the price of imports.

Some types of base broadening will have a salutary economic effect by changing tax policies that distort production and investment decisions. Others, particularly those that increase the effective tax rate on new investment, may prove damaging to the economy in the longer term by discouraging the kind of equity investment and entrepreneurship that enhances productivity and living standards.

In many countries, particularly those with extensive social welfare programs, the desire to hold down income tax rates has resulted in the adoption of broad-based consumption taxes — in particular, the value-added tax (VAT) — as an additional revenue source. Indeed, as Dutch tax specialist Sijbren Cnossen has noted,

> [a] major wave of tax reform is the adoption by seventeen out of twenty-four OECD member countries of the consumption-type, destination-based, value-added tax, collected through the tax credit or invoice method. The value-added tax has become a permanent feature of the tax mix in most countries.[20]

Aside from allowing income tax rates to be reduced, the VAT has the most desirable design features for a consumption tax:

> [t]he turnover...tax, the manufacturer's sales tax, the wholesale sales tax, and the VAT....each of these taxes discriminates less than its immediate predecessors among types of business and methods of doing business....[t]he VAT is the latest and probably the final stage in a historical development of general sales taxation at the national level.[21]

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[20] Sijbren Cnossen, "Overview," in Pechman, ed., *World Tax Reform*, p. 262.

[21] Carl Shoup, quoted in Graham Bannock, *VAT and Small Business: European Experience and Implications for North America* (Willowdale, Ont.: Canadian Federation of Independent Business, 1986), p. 27.

From a global perspective, the VAT is an ideal tax because it eliminates the biases of other indirect taxes against exports and in favor of imports. Canada's manufacturers' sales tax (MST), for example, hurts competitiveness by raising the price of exports by about 1 percent (equivalent to something in excess of 10 percent of the profit margins of Canadian exporters of manufactured goods).[22] The MST also has the dubious distinction of being the only national sales tax in the world known to favor imports over domestically manufactured goods. In today's competitive global markets, penalizing exports and favoring imports through the use of an antiquated tax is a folly that no country can afford.

Conclusion

The single thread connecting this discussion of forces of change is that no country can isolate itself from the increasing interdependence of global society. The countries that succeed in the 1990s will be those that best anticipate and adjust to the major changes that are taking place. Within individual countries, this is a task for all of the major actors — governments, business, and labor unions. It is also a task that requires greater cooperation among countries.

From a Canadian perspective, public- and private-sector decisionmakers need to recognize that:

- citizens' demands for actions that halt and reverse environmental degradation will not abate;
- pressures to adjust to the impressive pace of technological change, particularly through policies that encourage labor-market flexibility, will, if anything, accelerate;
- the crowding of the planet (particularly in the developing countries) and the aging of the population (particularly in

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22 Department of Finance, *Sales Tax Reform* (Ottawa, June 1987), p. 37.

the industrial countries) will place immense strain on existing immigration, pension, and health-care policies;
- the "globalization of everything" will make financial capital and manufacturing activity increasingly footloose;
- the multipolarization of global economic power will increase the need for export-oriented economies to diversify their trade among higher-income but slower-growing regions on the one hand, and lower-income but faster-growing regions on the other;
- the continuing trend toward regional economic blocs will intensify the need for countries to maintain access to large markets and will require increased political commitment to multilateral trade rules under the GATT to ensure that regional integration does not spawn interregional protectionism;
- the growth of world debt will mean that those countries with strong national balance sheets will be best able to weather recession and financial market turbulence;
- the trend toward lower income tax rates in the industrial countries will limit the ability of national policymakers to use tax breaks that narrow their tax bases to pursue social and economic objectives. At the same time, the desire to maintain lower income tax rates will continue to put pressure on governments to adopt broad-based, nondistorting consumption taxes such as the VAT.

No country can pursue economic initiatives any longer without considering the feedback effects from the world economy. This is as true for larger countries such as the United States and Japan as it is for Canada. In framing policies for the next agenda, Canadian policymakers must always keep firmly in mind the opportunities and constraints imposed by global forces.

4

The Next Agenda

The 1988 federal election campaign precipitated an historic debate between the advocates and opponents of the Canada-U.S. Free Trade Agreement. The election was not, however, simply a referendum on free trade. Voters were presented with such issues as the various parties' competence to manage the economy, their spending promises relating to a wide array of government programs, their ability to control the deficit and manage the country's huge national debt, environmental protection, and defense policy, to name some of the more prominent ones. In the final analysis, as in previous elections, a constellation of issues likely determined voting patterns, although in 1988 free trade was clearly at the center of the constellation.

Just as the result of the massive Conservative victory over the incumbent Liberals in 1984 was interpreted as a mandate for change, so most observers saw the government's re-election as a mandate to continue with the economic and political agenda it had established during the 1984–88 period. The government itself interpreted its new majority as a mandate to proceed with free trade and the Meech Lake Accord.

The Mandate and the Challenge

There is important unfinished business in several areas of the federal government's economic policy agenda, including:

- further reduction of the federal budget deficit;
- Stage II of tax reform, focusing on reform of the federal sales tax;
- further efforts to contain inflation and eventually achieve price stability;
- continuation of negotiations in the Uruguay Round of the General Agreement on Tariffs and Trade (GATT), with particular emphasis on the reduction of trade-distorting agricultural subsidies;
- implementation of the Free Trade Agreement and the five-to-seven-year negotiations with the United States on countervailing duty and antidumping laws;
- continuation of deregulation and privatization programs;
- implementation of a new science and technology strategy.

If the government is to manage this economic agenda successfully, it will have to address another area as a matter of the highest priority — social policy. If the election debate on free trade demonstrated anything, it was that many Canadians want assurance that the Agreement will not undermine Canada's social programs. The debate, however, obscured the fact that Canada's social programs are badly in need of reform. The Macdonald Commission, for example, criticized the existing system of benefits to the elderly, to families, to the unemployed, and to welfare recipients as ineffective in alleviating poverty, too complex, destructive of work incentives, an obstacle to needed economic adjustment, and potentially unsustainable as the population ages.[1]

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[1] Royal Commission on the Economic Union and Development Prospects for Canada [Macdonald Commission], *Report* (Ottawa: Supply and Services Canada, 1985), Vol. 2, p. 283.

Thus, there is a strong case for tackling social policy reform for its own sake. The case is further strengthened, however, by the need to pursue the key economic policy priorities listed above. In tackling the federal budget deficit, the government should focus its efforts not on cutting social benefits but on designing more effective programs that promote growth and help reduce unemployment and welfare dependency. In pursuing sales tax reform, it should ensure that the progressivity of the tax system is maintained through the provision of low-income tax credits. Finally, in pursuing enhanced competition through trade liberalization, deregulation, and privatization, the government should ensure that its labor market policies facilitate adjustment for Canadians who must change jobs, relocate, or upgrade their skills.

If these social policy imperatives are not fulfilled, the government can expect resistance to its economic policy agenda. To succeed, it will first have to convince Canadians that, as much as they value their existing social programs, changes can and, indeed, must be made to ensure that they are able to withstand the fiscal, economic, and demographic challenges of the 1990s.

The remainder of this chapter identifies in greater detail the economic and social policy agenda Canadians face over the next four years. As environmental considerations also need to be better integrated with economic policy decisions, some thoughts are offered on this important issue. Finally, the chapter concludes with the Institute's recommendations for Ottawa's next agenda.

Fiscal and Monetary Policies

Cutting the Deficit

Canada's success or failure in reducing its fiscal deficit will have important economic consequences over the next several years. Deficit reduction should have received more attention in the federal election campaign, because the country's fiscal situation cannot be said to be healthier in 1989 than it was in 1984, for several reasons.

First, although the deficit declined substantially to below 5 percent of GDP, as shown in Figure 7, the momentum of deficit reduction has dissipated, leaving the deficit at a level that is still far too high.

Second, the budget deficit in 1988 was mostly structural, rather than cyclical, in nature — that is, the deficit did not result from the economy's operating below full employment. During 1988, the unemployment rate dropped to near its 1981 level, prompting economists to begin estimating the unemployment rate associated with full employment and stable inflation — the so-called nonaccelerating inflation rate of unemployment, or NAIRU. Most estimates indicate that unemployment has dropped to within a percentage point of the NAIRU. This means that there is no longer a significant cyclical component to the budget deficit; rather, there is a structural imbalance between revenues and expenditures.

Third, with the public debt expected to rise to $320 billion, or 54 percent of GDP, by March 1989, the debt poses a substantially greater vulnerability to federal finances in early 1989 than it did in 1984, when it was just over 40 percent of GDP. To illustrate, in 1984 a sustained one percentage point rise in interest rates would have added about $1–1.5 billion to the deficit. In 1989, the same sustained one percentage point rise in interest rates would add almost $3 billion to the deficit.

Fourth, the federal debt is not the only government debt to have escalated since 1984. Provincial, local, and hospital-sector debt has also been on the rise relative to GDP. The combined debt of the three levels of government will hit 70 percent of GDP in this fiscal year compared with just over 50 percent in 1984.[2] For those who minimize the risks of debt-to-GDP

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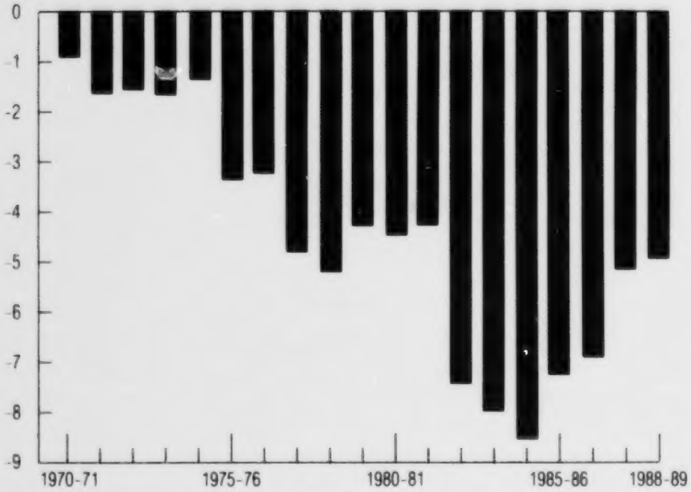
[2] These figures are based on research on provincial, local, and hospital-sector finances that is currently under way at the C.D. Howe Institute.

Figure 7
Canada's Federal Budget Deficit, fiscal years 1970–71 to 1988–89[a]
(as a percentage of GDP)



[a] **Data for fiscal year 1988–89 are projections by the Department of Finance.**
Source: Department of Finance, *The Fiscal Plan* (Ottawa, February 1988).

ratios of 70 percent or more, the example of Ireland, as shown in Box 2, may be instructive.

To sum up, the budget deficit, at 4–5 percent of GDP, is still too high; it is mostly structural; public debt is a substantially larger burden on the economy than it was in 1984; and combined federal, provincial, and local government debt has risen to a dangerous 70 percent of GDP. For all these reasons, Canada is in poorer fiscal health in 1989 than it was in 1984.

Targets and Options

What should be the targets for fiscal policy in the next agenda and what are the options for achieving them?

Box 2
The Consequences of Public Debt: The Case of Ireland

In the late 1970s, Ireland's debt-to-GNP ratio was 70 percent. From 1977 to 1981, real growth averaged 4.1 percent but large budget deficits continued to push the debt-to-GNP ratio above 80 percent. When the 1981-82 recession hit, the budget deficit increased sharply, pushing the debt-to-GNP ratio to 100 percent by 1983. By 1986, the Irish government had raised taxes to 47 percent of GNP from 45 percent in 1981 and reduced non-interest spending to 48 percent of GNP from 53 percent. In spite of these moves, the rising interest bill, which increased to 12 percent of GNP from 8 percent, has meant continuing deficits and a debt-to-GNP ratio of over 130 percent.

Ireland's deepening fiscal crisis has forced the government to apply tough fiscal restraint, including cuts in government programs and higher taxes. The restraint has depressed the economy. By 1988, real GNP was no higher than it was in 1983 and still 2.5 percent below its 1981 level. Real consumer expenditures, after declining sharply in 1982–84, have yet to return to their 1981 level. Capital investment has declined for six consecutive years. In spite of five years of restraint, Ireland's debt-to-GNP ratio continues to rise. The OECD recently estimated that if Ireland could cut its deficit to 4 percent of GNP by 1990 from 9.5 percent in 1988, the debt ratio would stabilize at 145 percent and decline to 125 percent by 1995. This would involve, however, another aggressive effort to cut the deficit. (Organisation for Economic Co-operation and Development, *OECD Economic Surveys: Ireland* [Paris, 1987].)

The C.D. Howe Institute's view is that the federal budget deficit should be cut sufficiently over the next four years to stabilize *and begin to reduce* the ratio of federal debt to GDP. The February 1988 budget projected that the debt-to-GDP ratio would begin to decline in the early 1990s if the economy experiences no recession and declining interest rates. This strategy relies too much on good luck.

A more realistic target would be to cut the budget deficit in half over the next four years through reductions averaging $4 billion annually. The best strategy would be to achieve significant deficit cuts in the next two fiscal years, offset by a more accommodative monetary policy. This would stop and firmly reverse the 15-year rise in the ratio of public debt to GDP and greatly reduce the economy's vulnerability. The experience of fiscal year 1985–86 demonstrated that the deficit can decline sharply without slowing the economy's growth, if monetary policy plays an accommodative role. Indeed, the shift in the fiscal-monetary policy mix would keep interest rates lower than they otherwise would be, thereby helping to reduce federal interest payments on the debt.

The Institute has argued since 1984 that the most acceptable strategy for reducing the budget deficit involves a balanced program of expenditure restraint and revenue increases. Achieving the target of reducing the deficit by $15 billion by 1992–93 would require that the primary deficit — that is, the deficit excluding interest payments on the public debt — be reduced by $13 billion. This could be achieved through continued expenditure restraint along with a program of privatization augmented by tax-rate increases sufficient to meet the annual target. Thus, a balanced program, would involve reducing spending by $6 billion per year, reducing net expenditures by $3 billion per year through privatization, and increasing revenue by $4 billion per year, all by fiscal year 1992–93.

It will not be easy to achieve this deficit-reduction target. This is because most of the obvious and least painful methods of cutting the deficit have already been adopted. Table 15 helps to analyze options that still exist.

Expenditure Options

On the expenditure side of the budget, the biggest single item is interest on the public debt. In fiscal year 1988–89, this will amount to $32 billion, or 25 percent of total government spending. Little can be done directly to reduce public debt charges. If the government can secure deficit cuts elsewhere,

Table 15
Structure of Federal Expenditures, fiscal year 1988–89

	($ billions)	(percent)
Total federal expenditures	132	100
Public debt interest	32	25
Program expenditures	*100*	*75*
Nonstatutory	41	31
Defense and ODA	13	10
Other	28	21
Statutory	58	44
Transfers to persons	28	21
Transfers to provinces	17	13
Other	13	10

Source: Department of Finance, *The Fiscal Plan* (Ottawa, February 1988).

however, reductions in debt service can be induced, providing an extra dividend.

In fiscal year 1988–89, program expenditures will amount to exactly $100 billion, approximately 60 percent of which will be for statutory programs and the rest going to nonstatutory programs.

Of the nonstatutory program total, $28 billion is being spent on programs other than defense and official development assistance (ODA). Current dollar spending on these programs is no higher in fiscal year 1988–89 than it was in 1984–85. This implies a real reduction in these nonstatutory programs of more than 15 percent, which is unprecedented in Canada's recent fiscal history. It has also been achieved in spite of some special emergency expenditures — such as the Special Canadian Grains Program, which has been adding about a billion dollars annually to nonstatutory program expenditures in recent years.

These exceptions aside, nonstatutory programs bore the brunt of expenditure restraint over the 1984–88 period. Nevertheless, growth of nonstatutory expenditures must continue to be restrained in the future. In particular, this will involve restraining or cutting expenditures in the economic development envelope, which totaled $13.4 billion in fiscal year 1988–89. In future, expenditure reductions of over $1 billion per year could be achieved by scaling back subsidies to business distributed through, for example, the Industrial and Regional Development Program, the Special Canadian Grains Program, the Canadian Dairy Commission, and a variety of transportation subsidies.

The next major block of expenditures is that for national defense and ODA, which will account for 13 percent of program spending in fiscal year 1988–89. Spending in these categories, unlike that for other nonstatutory programs, has increased by 30–35 percent since fiscal year 1984–85. This is, of course, part of Canada's effort to meet its international commitments on both defense expenditures and development assistance. While these commitments are important, Canada's long-term ability to meet them depends on its ability in the near term to correct its serious budget imbalance. Considerable savings — at least $1 billion annually — could be achieved by extending the period over which Canada seeks to achieve defense and foreign policy objectives.

By far the biggest portion of federal program spending is on statutory programs — $58 billion in fiscal year 1988–89. About half of this total is made up of personal safety net expenditures — unemployment insurance, pensions, family allowances, and Canada Assistance Plan expenditures.

As is discussed later in this chapter, Canada's social policy network is in need of an overhaul. The main objectives should be to ensure that the safety net provides adequate assistance for low-income Canadians and to eliminate the serious poverty traps that exist in the current system. Comprehensive reform — with participation by the provinces — will be required to achieve these objectives, but the payoff in terms of improved opportunities for Canadians would be substantial. Such reform cannot be accomplished overnight; nor should it focus on cutting social program spending as an objective per se. If the reform is successful, however, reducing the number of people dependent on government assistance will, with time, pay a significant fiscal dividend.

What is the bottom line on options for expenditure reduction? Clearly, more needs to be done. Further efforts at restraining expenditures will be essential but increasingly difficult. The best approach will be to keep the growth of program spending below the rate of growth of the economy through continued, across-the-board fiscal restraint.

Revenue Options

On the revenue side, the February 1988 budget anticipates a small decline in the ratio of federal revenue to GNP in fiscal year 1988–89. This would be desirable, especially if expenditures were to drop by 2 percent of GDP over the next four years as projected in the February 1988 fiscal plan. This expenditure decline depends, however, on four more years of economic growth and declining interest rates. The real question for the revenue side is: What if this positive economic scenario does not work out?

Two broad revenue-raising options exist, the first relating to privatization and the second to general tax increases. In its first term, the government made only a modest beginning at privatizing Crown assets and operations. The fiscal benefit of privatization, as the United Kingdom has shown, is that it can raise substantial revenues (or lower expenditures), reduce the net debt, and reduce interest payments on the debt while growth in the economy helps bring program expenditures and revenues more closely into line.[3] Thus, a concerted effort to reduce the deficit by $3 billion per year by fiscal year 1992–

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[3] The sale of public assets, by itself, will not necessarily reduce the structural imbalance between revenue and expenditures. Privatizations can reduce this imbalance, however, if they end the fiscal drain associated with money-losing government enterprises, if they reduce spending through contracting out, or if they reduce the federal debt and associated interest payments.

93 through privatization could make a significant contribution to deficit reduction in the next agenda. Some options for meeting this target are discussed later in this chapter.

The other major option on the revenue side is to raise taxes. With the 1987 tax reform, personal and corporate tax bases have been broadened. The federal government has also undertaken temporary measures to halt the erosion of the federal sales tax base. Tax reform has reduced the options on the revenue side in one sense by eliminating most of the obvious large tax deductions and exemptions that might have been reduced to raise revenues. Thus, the only remaining option is to increase tax rates.

The C.D. Howe Institute calculates that an across-the-board increase in personal income tax rates by 1 percentage point could raise $3.3 billion in revenues, an increase of 1 percentage point in the effective corporate tax rate could raise $600 million dollars, and an increase of 1 percentage point in the existing federal sales tax rate could raise $1.1 billion.[4] If Stage II of tax reform is implemented, an increase of 1 percentage point in the proposed National Sales Tax rate could raise $2.5–3.0 billion annually. Thus, the federal government has or will have at its disposal a range of tax bases that could be drawn on to raise an additional $4 billion per year by fiscal year 1992–93 to help reduce the deficit.

The federal budget deficit can and should be reduced substantially, not for its own sake but to reduce the vulnerability of the Canadian economy in the short term and to improve growth and living standards in the long term. Measures the government takes now will pay substantial dividends in terms of reduced public debt charges later.

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[4] These figures make no allowance for the potential erosion of the corporate and sales tax bases that might accompany a tax-rate increase. In the absence of similar increases in U.S. tax rates, Canadian taxpayers would take actions to reduce their Canadian tax liabilities, which would reduce the revenue yield of the tax-rate increases.

Pursuing Price Stability

An important priority of the next agenda will be to contain inflationary pressures in the near term and pursue price stability over the medium term. The experience of the 1970s showed that inflation is so costly to reduce once it becomes entrenched that the best policy approach is not to permit any sustained rise at all.

The Bank of Canada has the main responsibility for guarding against the buildup of inflationary pressures. By taking steps, beginning in mid-1987, to head off inflationary pressures, the Bank signaled a subtle, but highly beneficial stance of monetary policy. This stance has three elements:

- the willingness to adopt a more restrictive policy based on early warnings of inflationary pressures, rather than waiting for broad measures of inflation — such as the rate of increase of the Consumer Price Index — to move higher;
- the willingness to resist inflation, even if doing so puts upward pressure on the Canadian dollar; and
- the announcement that the medium-term objective of monetary policy is not just to resist increases in inflation but eventually to achieve stable prices.[5]

So far, the Bank's strategy has succeeded, but, as pointed out in Chapter 2, too much of the burden of containing inflation has been borne by monetary policy. The failure to adopt a more restrictive fiscal stance, not only at the federal level but also in some of the provinces, has contributed to stronger demand growth and greater inflationary pressures.

In 1989 and beyond, the Bank's task will be to remain vigilant and contain inflationary pressures as they arise.

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[5] John W. Crow, "The Work of Canadian Monetary Policy," Eric J. Hanson Memorial Lecture, University of Alberta, January 18, 1988. Reprinted in *Bank of Canada Review*, February 1988, pp. 3–17.

Failure to do so could lead to a repeat of the mistakes of the 1970s — an entrenched inflation that can only be reduced by monetary actions that bring on recession. The task will be made easier and the outcome for economic growth and inflation will be better, however, if federal and provincial fiscal policies play a more positive role by helping to contain excessive growth of demand both nationally and in high-employment areas of the country.

Tax and Social Policies

Tax Reform

Although the Conservative government undertook a far more substantial tax reform than it had anticipated in its *1984 Agenda,* much remains to be done. Stage I of tax reform met the challenge of the U.S. reform, but it did not address some of the worst flaws of the tax system.

The next agenda for tax reform contains three important priorities: sales tax reform, a re-examination of the investment income provisions, and improved integration of personal taxes and transfers.

Sales Tax Reform

The arguments for replacing the federal manufacturers' sales tax (MST) with a broad-based, multistage sales tax are by now well known. The existing tax weakens Canada's international competitiveness, distorts consumer choices, is unfair in its application across industries and firms, reduces competition, and discourages new manufacturing investment. There is no question among tax specialists that the MST must go. The only question is: What will replace it?

The federal government has proposed three options for reform, but clearly favors the National Sales Tax option. This option would see both the federal MST and provincial retail sales taxes replaced by a single valued-added tax base, to which the federal government and each province would apply its own rate. A National Sales Tax would have numerous advantages over the existing system:

- it would be broad based, covering most goods and services, thereby eliminating the uneven impact of the existing tax;
- it would tax imports at the same rate as domestic goods and exempt exports, thereby putting Canadian goods on an equal competitive footing with foreign goods;
- it would be less costly to administer, because it would tax most goods and services at the same rate rather than distinguishing between different types of goods;
- it would reduce administrative costs for government and compliance costs for business by eliminating the duplication of separate federal and provincial collection systems;
- it would eliminate the taxation of business inputs by provincial retail sales taxes, further improving competitiveness.

What about the potential disadvantages of a National Sales Tax? The two most important are that the new tax would increase taxes for low-income households and that the federal government might use it as a "money machine" to generate large amounts of new revenue. Both concerns deserve attention.

First, while it is true that sales taxes can be regressive — that is, they can bear more heavily on low-income households — this effect can be fully (or more than fully) offset by combining it with an enlarged refundable sales tax credit. The federal government already has in place a refundable sales tax credit of $70 per year. This credit could be increased under sales tax reform to, perhaps, $300–400 per year for a single person. The figure should be set so that it fully offsets the impact of the new sales tax on low-income families. It could be enriched in future to improve the tax position of these people. Some astute antipoverty groups applaud the government's commitment to accompany the new sales tax with an enlarged sales tax credit. They recognize that the new system, if properly designed, can make low-income Canadians better off.

The second concern is that a National Sales Tax would be used to collect billions of dollars of federal revenue. Indeed it would. But it need not collect a single dollar of *additional* revenue. The current proposal, though vague, suggests that all of the $23 billion of federal revenue that could be raised by an 8 percent National Sales Tax would be used to reduce other taxes, as shown in Box 3.[6]

These figures are rough approximations, but they illustrate the point. Sales tax reform can and should be revenue neutral. This does not rule out the possibility that the tax might be increased in future, to fund new social programs or to tackle the budget deficit. If new taxes were needed, however, a broad-based sales tax would be a fairer and less distortionary tool with which to do the job.

Investment Income Provisions

The government should make increasing the supply of equity finance a priority in its second term. To be competitive, to grow, and to create jobs, Canadian companies need access to financial equity. If equity capital is to be supplied, not just by the wealthy but by Canadians with more modest incomes as well, the treatment of equity investment income will need to be as attractive as the treatment of income from other sources.

The Stage I reforms relating to personal investment income amounted to a significant hike in the effective tax rate

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[6] See Thomas J. Courchene, "Tax Reform: The Impact on Individuals," in Edward A. Carmichael, ed., *Tax Reform: Perspectives on the White Paper*, Policy Study 4 (Toronto: C.D. Howe Institute, 1988), pp. 22–24.

Box 3
Disposition of Revenues from Proposed National Sales Tax

Elimination of existing manufacturers' sales tax	$15 billion
Expanded sales tax credit for low-income households	3 billion
Further reduction of personal income-tax rates for middle-income taxpayers	3 billion
Elimination of personal and corporate surtaxes	2 billion
Total revenue to be raised by National Sales Tax	*$23 billion*

on such income. To a degree, this was justified and necessary in a reform that emphasized lowering rates and broadening tax bases. The base broadening may have gone too far, however, in pursuit of revenue neutrality, resulting in a serious and unwarranted reduction in the after-tax return on investment.

Two aspects of the treatment of investment income warrant reconsideration. First, it may have been unwise to increase the proportion of taxable capital gains to 75 percent from 50 percent. Economic evidence suggests that lower effective tax rates for capital gains encourage individuals to realize more capital gains, which both increases tax revenues and frees up equity capital to move to more productive uses. U.S. President George Bush has indicated his administration's intention to re-examine the increase in the capital gains tax that occurred as part of that country's 1986 reform. Canada should do the same.

Second, it was unwise to continue the practice of taxing nominal, rather than inflation-adjusted, capital gains. This can result in negative real after-tax returns and greatly discourage investment as inflation rises. Since the complete elimination of inflation, though desirable, is unlikely, it would be preferable to tax only inflation-adjusted capital gains. Such a change would strengthen the case for full inclusion of capital gains in taxable income.

These are difficult but important issues. Unfortunately, many Canadians interpret more favorable treatment of investment income as a benefit only to the wealthy. The evidence does not support this view. Many Canadians with average incomes — and below-average incomes in the case of older Canadians — receive a significant portion of their annual income in the form of dividends and capital gains. Unfavorable tax treatment should not discourage wider ownership of equity investments. Furthermore, a much broader group of working Canadians benefits from the economic growth and jobs that a healthy climate for equity investment by individuals can provide.

Tax-Transfer Integration

As Chapter 2 pointed out, the tax reform process has not addressed in a serious way the interaction between the tax and transfer systems. The Ontario government's Social Assistance Review Committee observed the following about the work-welfare system:

> The current system was designed more than a quarter of a century ago. It fails to meet the basic income needs of recipients. Equally important, the system does very little to encourage recipients to increase their capacity for self-reliance. In many cases, it actually discourages people from leaving social assistance.[7]

The most serious rebuke of the system concerns its perverse treatment of individuals who move from welfare to work. A welfare recipient who accepts a minimum-wage job faces a marginal tax rate of almost 100 percent in most provinces, and higher if one takes into account the loss of such welfare-related benefits as drug plans and subsidized housing. In an overall financial sense, individuals are often no better off, and can be worse off, when employed than when receiving assistance. Figure 8 illustrates this situation, based on 1983 data for a representative single-parent family in Toronto.

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[7] Ontario, Social Assistance Review Committee, "SARC Releases Report with Emphasis on 'Transitions' for Recipients," *News Release*, Toronto, September 6, 1988

Eliminating existing poverty traps within the work-welfare system will require reductions in the implicit tax rates facing Canadians who work for low wages. But serious reform will involve considerably more. It will require focusing on how the after-tax situation of individuals is affected by all aspects of the tax and transfer system, administered by all levels of government. It is only by rectifying the highly variable treatment individuals face when moving from one tax or assistance bracket to another that the system will become more equitable and encourage more self-reliance.[8]

The Macdonald Commission and other, in-depth examinations of social policy reform took tax-transfer integration to its logical conclusion by recommending some form of Guaranteed Annual Income (GAI) or Negative Income Tax. Such a system would replace many currently available tax breaks and transfers with a basic income supplement or refundable tax credit for all Canadians that would decline as income increases. By taxing at a low rate income earned above the basic guaranteed level, the system would send the correct signals to those able to work.

A GAI scheme might be beyond Canada's grasp in the short term because of the costs and political difficulties inherent in major social policy change. Incremental changes to existing programs can be undertaken, however, with the goal of a GAI in mind.

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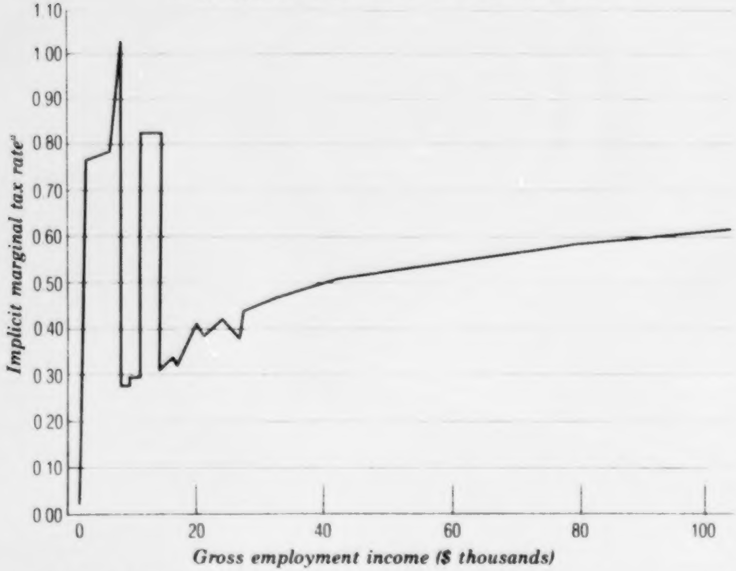
[8] On its own, the federal government cannot go far in this area. With the cooperation of the provinces, however, payroll taxes for low-income Canadians could be reduced.

Figure 8
Marginal Tax Rate by Level of Employment Income in Toronto, 1983



[a] Head of a single-parent family working 25 hours per week, 52 weeks per year, two children under six years of age, one child in day care, rent $3,600 per year.

Source: Bernard Fortin, "Income Security in Canada," in François Vaillancourt, ed., *Income Distribution and Economic Security in Canada*, Collected Research Studies of the Royal Commission on the Economic Union and Development Prospects for Canada 1 (Toronto: University of Toronto Press, 1985), p. 169.

One step in the direction of tax-transfer integration would be to convert remaining tax deductions to tax credits. Among the remaining deductions are those covering registered pension contributions, moving expenses, and child-care expenses. Another step would be to make more of the existing tax credits refundable. These moves would increase the progressivity of the tax system. By ensuring that Canadians who do not pay taxes receive refundable credits, it would also guarantee that some minimum benefits are available to all.

An immediate priority in the area of tax-transfer integration is for governments to reduce the confiscatory implicit tax rates that individuals face when they move from welfare to work. This can be achieved through lower tax rates and/or retention of some social assistance for Canadians who earn low wages. Much of the responsibility for improvements to the system lies with the provinces, both on the tax side and in the allocation of welfare transfers and benefits.

Prospects for success in better integrating the tax-transfer system can be improved by moving ahead with Stage II of tax reform. The revenue generated by a National Sales Tax would permit substantial reductions in personal income tax rates. The federal government should use the opportunity of Stage II reform to make substantial changes in the signals the tax system gives Canadians and to develop a tax-transfer network that adequately provides for low-income Canadians while encouraging growth, self-reliance, and initiative.

Social Policy

The major challenge facing governments in the 1990s will be to integrate social policy into the economic mainstream. This will require a better interaction between different aspects of the social policy network — transfers, taxes, and institutions — and between social policy and employment policy, fiscal policy, and other aspects of economic policy. The goal should be a social security system that permits a sensitive treatment of low-income Canadians without imposing too high a cost on economic adjustment and economic performance. This can be accomplished by improved targeting of social benefits, but this in itself raises difficult decisions and poses numerous policy challenges.

In addition to the better integration of taxes and transfers discussed earlier, this chapter considers specific challenges in the social policy area from reforms to unemployment insurance and elderly benefits.

Unemployment Insurance

Reform of the unemployment insurance (UI) system is long overdue. The current system attempts to satisfy too many objectives — pure employment insurance, income support, regional development, maternity and sickness benefits, among others — and accomplishes none particularly well. In struggling to deliver on too many socio-economic goals, not only has the UI system weakened its pure insurance function, but it has also seriously impeded labor market adjustment and fostered dependence on the system in far too many instances.

Studies of the UI system conducted over the past several years have uncovered striking illustrations of how it has distorted labor market behavior by encouraging short-term employment in seasonal industries at the cost of more stable work patterns.[9] Although many have been tempted to blame recipients for the abuse that occurs, the fault lies more fairly with the design of the program. As Thomas Courchene points out, recipients are responding quite rationally to incentives embodied in the system itself.[10]

Many studies argue that the income-support components of the UI system should be incorporated into a separate program, and they generally agree that the UI component should:

- relate the duration of benefits more closely to the weeks of previous employment;
- increase the number of weeks worked in order to qualify for benefits;

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[9] See, for example, Newfoundland, Royal Commission on Employment and Unemployment [Howse Commission], *Building on Our Strengths* (St. John's: Queen's Printer, 1986).

[10] Thomas J. Courchene, *Social Policy in the 1990s: Agenda for Reform*, Policy Study 3 (Toronto: C.D.Howe Institute, 1987), p. 71.

- treat workers in different parts of the country the same; and
- ease the transition from unemployment to work by permitting more part-time or temporary earnings while employed and/or allowing more tax-free employment earnings.

Unemployment insurance is the classic case of a social policy whose reform would contribute significantly to higher economic growth and a better use of labor resources. Thus, lack of an economic rationale was not the reason for the government's reluctance to reform the system during its previous term. Rather, the reason was political in nature, and politics inevitably will determine future decisions regarding unemployment programs.

It is possible that, because of current concern over labor adjustment as a result of free trade, there is a window of political opportunity to tackle reform of the UI system. Presumably, the impact of labor market programs such as UI on the adjustment process is a focus of examination by the de Grandpré Commission. As is discussed in more detail later in the chapter, the federal government should grasp the opportunity offered by the de Grandpré Commission's examination of the need for trade-related adjustment assistance and the heightened awareness of labor adjustment to undertake long overdue reforms to the present system.

Reform of the UI system would be more effective and easier to achieve if accompanied by reform in other areas of the social policy network. Improved labor training and adjustment programs would reduce reliance on UI, as would a better-designed social assistance scheme, such as the Universal Income Security Plan recommended by the Macdonald Commission. Savings from eliminating the income-support components of the current system could be used to finance special income or regional assistance programs when required. Indeed, one approach to the reform process would be to experiment with a revamped UI and income assistance scheme in

Newfoundland, where unemployment is chronically high. This could demonstrate the advantages of such a system and provide an opportunity to work out any difficulties prior to its introduction on a national basis.

UI reform poses many difficulties but promises significant economic benefits over the longer term. The government is well acquainted with the rationale for change, and the issue of labor adjustment under free trade has given it an opportunity to act. The government felt that UI reform was too political an undertaking during its previous term. It is unlikely to be any easier over the next four years. Gradual change and the provision of income support programs during the transition can minimize the concerns of provincial authorities and UI recipients and realize longer-term benefits.

Elderly Benefits

The demographic challenge of an aging population has made reform of elderly benefits a pressing issue. The fiscal challenge to policymakers is to find ways of limiting spending to manageable proportions while still responding to the growing needs of the elderly for health care, pensions, and other support. Moreover, the money will have to come from a smaller proportion of population of working age than exists today.[11]

Public support of the elderly now consists of:

- direct transfers, in the form of Old Age Security (OAS) for all persons aged 65 years and over and the Guaranteed Income Supplement (GIS) for low-income elderly; and
- tax expenditures in the form of the old age exemption, pension income deductions, and deductions for contributions to private pension plans.

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[11] See Organisation for Economic Co-operation and Development, *Ageing Populations: The Social Policy Implications* (Paris, 1988).

The combined impact of the transfer and tax provisions is such that every Canadian over the age of 64 is ensured an after-tax income of approximately $6,500, regardless of his or her income level. Federal budgetary and tax expenditures on the elderly totaled $13 billion in 1986, almost three times the amount spend on family benefits.[12]

Thomas Courchene has spelled out the chief concerns with current tax and transfers provisions for the elderly:

> It is difficult to escape the conclusion that, overall, *the tax transfer treatment of the upper-income elderly is too generous*. This conclusion is of particular concern because the proportion of the elderly that falls into upper-income categories is certain to increase dramatically. The substantial improvements in private- and public-sector pension plans, combined with the very substantial and rapidly growing amounts in RRSPs, virtually guarantees this outcome.[13]

Among the options to target elderly benefits better are to "claw back", through steeper tax rates, OAS payments to high-income elderly and to cap the old age tax credit and make it refundable.

While benefits should be reduced for high-income elderly, they should be increased for some low-income seniors. A case in point is older women, who have tended to fall through the cracks of the various programs geared to the elderly. Until quite recently, private pension plans were often unavailable for women workers, many of whom now find themselves approaching retirement age without access to private pension income. Similarly, Canada Pension Plan payments accrue only to previous contributors, not to homemakers, while the Spousal Allowance program applies only to widows, widowers, or spouses, not to single people.

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[12] Department of Finance, Social Policy Branch, "Information on Selected Federal Social Tax/Transfer Programs" (Ottawa, September 1986, Mimeographed), Table A7.

[13] Courchene, *Social Policy in the 1990s*, p. 46.

OAS and GIS payments are usually inadequate without other means of support. Changes in the tax-transfer system to assist low-income individuals not eligible for pension income, particularly women, should be a priority of the reform process. In providing assistance for those with inadequate savings or retirement income, however, these measures should not discourage people from saving today for their old age.

A better targeting of elderly benefits is critical if Canada is to prepare its social policy network to meet the challenges of the twenty-first century. Benefits for high-income elderly should be reduced in the interests of equity and cost savings. Low-income elderly, especially women, must see their benefits improved if they are to escape an existence below the poverty line. Changes to the system should come soon, and should be well in place before the aging process significantly alters the distribution of Canada's population.

Broader Social Policy Objectives

The political difficulties associated with social policy change will be even more pronounced over the next four years than in the government's previous term. Canadians are aware of the government's assurances during the free trade debate that the Canada-U.S. Agreement will not affect social policies, and they will be sensitive to any changes in the status quo.

It would be most unfortunate if political considerations were to dissuade the government from reforming social policies, particularly the UI and work-welfare systems. Changes to increase tax and transfer benefits to low-income Canadians, to limit the growth in benefits to high-income elderly, and to reduce the excessive tax rates facing individuals who leave welfare for work would result in a more equitable system that better contributes to economic growth and adjustment.

Social policy reform initiatives should not be restricted to changes in taxes and program transfers, however, but should look to sociological factors affecting the distribution of income. For example, there is a high degree of correlation between poverty and illiteracy, and, for women, between poverty and marriage breakdown. The latter is particularly disturbing in light of the fact that women usually retain custody of children on separation or divorce. Statistics reveal that some groups predominate in the ranks of the poor: single mothers, elderly women, natives, and, to a lesser extent, immigrants.

This suggests the development of programs to address the root causes of the difficulties these groups face. Literacy and other adult education programs are a logical priority in this respect, since a focus on developing human capital also has a tremendous payoff in social terms. Further efforts to enforce support agreements in the event of marital breakdown would greatly assist women and children dependent on this support. Assistance with child-care expenses is also an important factor for low-income families, and recent child-care initiatives are a positive development in this respect.

Trade Policy

Multilateral Trade Negotiations

Many observers see the current Uruguay Round of GATT negotiations as critical to the future of the multilateral trading system. Never before has there been more active participation among the signatory countries to the GATT, with the newly industrializing countries playing an important role for the first time. GATT specialists are closely watching the dynamics of the negotiations, particularly the traditional leadership role of the United States and the possible preoccupation of the European Community (EC) with its 1992 program. Some are concerned that if the multilateral route yields only small gains, the United States will opt for a series of bilateral arrangements similar to the Canada-U.S. Agreement.

Canada, so dependent on foreign trade for its material prosperity, has a vital stake in an effective multilateral trading system. Its acceptance of closer trading ties with the United States thus does not mean that it should place less importance on the multilateral negotiations. On the contrary, an effective trade policy strategy for Canada must rely on both tracks. The Free Trade Agreement gives Canada preferential access to its largest export market; the GATT offers significant gains in access to the markets of other countries. Each offers gains that the other cannot provide.

In agriculture, for example, the Agreement contains important trade-liberalizing elements, but crucial reforms to trade-distorting subsidies can be effectively achieved only through the GATT. In government procurement markets, the Agreement offers Canada access to the lucrative U.S. procurement market, but greater multilateral liberalization in procurement can offer even more. In dispute settlement, the GATT provides Canada with a forum for dealing with trade disputes with countries other than the United States. In general, Canada also gains leverage in negotiations with countries other than the United States that currently export to Canada but that might lose some trade because of the preferential access given to the United States. Canada is in a good position to offer these countries reciprocal access for some goods or sectors, or in return for some other concessions.

GATT members met in Montreal in December 1988 for the Midterm Review of the Uruguay Round. The following sections outline Canada's key negotiating issues in the final two years of negotiations.

Agriculture

Canada attaches a high priority to negotiations addressing the proliferation of subsidies that distort world agricultural trade.[14] Negotiations on this issue stalled in Montreal, as much disagreement exists among countries that heavily subsidize their domestic producers but that are unwilling as yet to reduce these payments or to agree on any rules governing domestic agricultural policy. More importantly, the breakdown of negotiations in this area threatens the overall success of the Round.

The Midterm Review demonstrated how integral agriculture is to trade liberalization in other areas. There was no shift in the polarized positions of the United States and the EC on farm subsidy reductions, which, in the short term, suggests that meaningful reforms will be difficult. Also disturbing, from the point of view of success in the current Round, is that several countries have made it clear that concessions in other areas are contingent on progress on agricultural issues.

Services

The pressure to include trade in services in the GATT comes from the United States, but the developing countries — especially Brazil and India — are resisting it. Canada is interested in opening up foreign markets to international trade in services, where bilateral agreement with the United States has already been achieved.

A tentative agreement was reached at the Midterm Review to negotiate trade in services from a comprehensive perspective, including all sectors without exception. This is an ambitious and optimistic agenda, one that is likely to see continuing resistance, particularly from the developing countries. Canada can benefit from an agreement that binds as many GATT members as possible on rules for trade in services, since this trade is of growing importance to Canada, and since barriers to trade in services often turn into barriers to trade in goods and vice versa.

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[14] See J.C. Gilson, *The GATT Midterm Review and Agriculture: Prospects for Trade Reform in the Uruguay Round,* Trade Monitor 9 (Toronto: C.D. Howe Institute, 1988).

Dispute Settlement

Canada has a strong interest in the strengthening of the GATT's dispute settlement mechanism, in particular in moving to a rules-based system similar to the one contained in the Canada-U.S. Agreement. The current GATT mechanism is fundamentally a system of consensus and compromise. Most developed countries prefer a system with strict rules, procedures, and timetables for resolving trade disputes between member states.

Radical reform of these mechanisms is unlikely, but some incremental improvements likely will occur. GATT members tentatively agreed in Montreal to make dispute procedures more efficient and easier, to limit the time limits for panel reports to be issued, and to enforce the acceptance of panel recommendations by offending countries.

Countervail and Antidumping Codes

Countervailing duties are levied on imports to offset subsidies received by a foreign exporter. Antidumping duties are applied to imports when they are sold in foreign markets at prices below those at which they are sold in the home market.

At this stage of the negotiations, participants have simply submitted proposals for reform outlining their objectives for improving the existing GATT codes in these areas. These negotiations are important to Canada, not only to secure multilaterally agreed definitions of subsidies and criteria for antidumping practices, but also to help focus and push ahead the Canada-U.S. negotiations on these issues mandated by the Free Trade Agreement.

Nontariff Measures

A specific GATT Negotiating Group is examining ways to prevent or at least to reduce the use of nontariff barriers to trade. (Some of these nontariff measures are also being dealt with in the other working groups outlined in Table 8 in Chapter 2.) Such barriers have proliferated in recent years, and they undermine the tariff reductions obtained in previous GATT Rounds. The focus of this group is to deal with quantitative restrictions, voluntary export restraint agreements, and especially government procurement policies — one of the most significant nontariff barriers in use today.

Canada would like to obtain greater coverage for procurement through the GATT, since the Free Trade Agreement gives Canada access to only a small portion of the U.S. procurement market. Broadening the coverage of procurement codes through the GATT could offer even greater access to U.S. markets, and to those of the EC, and the European Free Trade Association (EFTA).

Tariffs

Canada would like to obtain better access to foreign markets, particularly for processed natural resources, by reducing tariffs and tariff escalation — the increasing rate of tariff applied to products as more value is added.

The prospect for tariff reductions in the Uruguay Round looks promising. Across-the-board reductions in the neighborhood of 35 percent are being discussed. However, these negotiations are unlikely to gain priority in the Round until it becomes clear that agreement is possible on other, more important issues. The importance of these tariff reductions for Canada is obvious. It is through multilateral reductions in tariffs that Canada can achieve better access to non-U.S. markets.

Other Important Areas of Relevance to Canada

The Uruguay Round is also attempting to deal with the sensitive issues of trade-related investment measures (TRIMs) and trade-related intellectual property rules (TRIPs). TRIMs relate mainly to various forms of performance requirements that domestic governments impose on foreign investors. TRIPs relate to the issue of obtaining greater protection of intellectual property rights — for example, patents, copyrights, and trade in counterfeit goods.

Both of these areas are contentious. Conflicts have arisen between the objectives of the industrialized countries on the one hand, and those of the developing countries on the other. No progress was made at the Midterm Review, and given the existing lack of consensus on these issues, positive results are unlikely to come until late in the negotiations, or even after the Round has concluded.

These new areas are important to Canada, for two reasons. First, Canada is often faced with meeting performance requirements as a condition of foreign investment, particularly in the resource sectors of developing countries. Second, Canada is a major trading country in high technology and has interests in curbing the abuse of trade in counterfeit goods.

Canada's Negotiating Strategy in the Uruguay Round

Canada enters the final two years of the Uruguay Round in a new position, having now joined with the United States in a free trade arrangement. In the past, Canadian negotiators spent a large portion of their scarce negotiating resources in dealing bilaterally on a broad range of issues with the United States. Now, however, Canada need not devote many of its resources to such bargaining. Instead, it can spend more time in trying to achieve gains in other foreign jurisdictions and in pursuing more specific areas of concern.

Having implemented the Free Trade Agreement, Canada has strengthened its hand in the GATT. Many issues in the multilateral negotiations overlap those involved in the Agreement, and many are also high on the agenda of the key GATT participants. While the United States, the EC, and Japan place various weights on these issues, all recognize the importance of significant progress in liberalizing measures for trade in services, trade-related investment issues, agriculture, and dispute settlement. On dispute settlement, for example, Canada can press hard to make the GATT's general dispute settlement principles more effective, and it can offer the Canada-U.S. dispute mechanism as a useful model to follow.

Canada's participation in the negotiations on these important issues, in order to improve access to other foreign markets, will increase its influence in the GATT and help it to achieve its goals in its own high-priority areas, such as better access for upgraded natural resource products. Canada can also gain influence through negotiating as part of a coalition such as the Cairns Group for agriculture. There may also be a role for Canada in helping to keep the momentum of the Round going, perhaps by bridging some of the differences between the developed and developing countries.

Canadian negotiators should push hard in the Uruguay Round to pursue access to foreign markets that are important for Canadian exporters. They should also play an active role in pursuing trade liberalization in the new areas — services, intellectual property rights, and investment — where Canada has already reached consensus with the United States and where significant benefits exist.

Implementing the Canada-U.S. Free Trade Agreement

Beginning in 1989, Canada will undertake almost complete trade liberalization with the United States, phased in over a ten-year period. The Free Trade Agreement gives Canada preferential access to one of the world's richest markets. This access gives Canadian producers an opportunity to rationalize to serve a vastly expanded market. It will also help Canadian firms generate wealth that will maintain Canada's high relative living standards and that is available to finance Canada's social programs.

The detailed framework for the Agreement is now in place. Arguably, however, the toughest parts of the government's trade policy agenda — implementation and future negotiations — await attention. Table 16 sets out the important dates for phasing in the terms of the Agreement.

Tariff Elimination

All bilateral tariffs are to be removed within ten years. Industries accounting for about one-half of bilateral trade will have their tariffs phased out in a series of equal annual steps. Industries accounting for about 35 percent of bilateral trade agreed to reduce this phaseout period to five annual steps, while those accounting for a further 15 percent decided to collapse it into one step, which was taken when the Agreement entered into force on January 1, 1989. Wherever both sides agree, the tariff cuts can be accelerated. Some industries have already requested that the cuts be made more quickly than originally agreed to in the tariff schedule, and a mechanism to deal with this already exists.[15]

In order to classify goods for tariff purposes — to determine country of origin and tariff reductions — the Agreement adopts the "Harmonized System" used worldwide. The Agreement sets out for almost every product the existing tariff, the

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[15] Accelerated tariff cuts are common in other trade-liberalizing agreements. In the EC, EFTA, and most recently in the Australia-New Zealand Closer Economic Relations Trade Agreement signed in 1983, the actual tariff cuts were brought in at about twice the speed that had originally been agreed to.

Table 16
Key Dates in the Canada-U.S. Free Trade Agreement

Date	Trade Restriction or Provision Being Eliminated
January 1, 1989	The Agreement comes into force. Tariffs in schedule A are eliminated, as are the first stages for those goods in schedules B and C.[a] The threshold for review of U.S. direct investment in Canada is set at C$25 million, and for indirect investment at C$100 million.[b] The five-year period for negotiating a bilateral code for subsidy and antidumping practices begins.
January 1, 1990	The threshold for review of U.S. direct investment in Canada is set at C$50 million, and for indirect investment at C$250 million.
January 1, 1991	The threshold for review of U.S. direct investment in Canada is set at C$100 million, and for indirect investment at C$500 million.
January 1, 1992	The threshold for review of U.S. direct investment in Canada is set at C$150 million, and for indirect investment the threshold for review is removed altogether.
January 1, 1993	All tariffs for goods in schedule B are eliminated. Negotiations to develop a bilateral code for subsidy and antidumping practices are concluded, with a possible two-year extension until 1995.
January 1, 1994	The use of duty drawbacks is removed.[c]
January 1, 1995	The use of duty remissions is removed for non-auto pact members.[d]
January 1, 1998	All bilateral tariffs are reduced to zero, except for those permitted on a temporary basis for safeguard purposes. The use of duty remissions on all bilateral trade is removed, including those given to auto pact members.

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[a] Tariffs are scheduled to be eliminated in one of three stages for all goods: on January 1, 1989, for goods in schedule A; in five equal annual steps ending on January 1, 1993, for goods in schedule B; and in ten years over ten equal annual steps ending on January 1, 1998, for goods in schedule C.

[b] Direct investments are acquisitions of Canadian firms by U.S.-owned firms; indirect investments are acquisitions by U.S.-firms of foreign-owned firms operating in Canada.

[c] A duty drawback is an import duty on tax repaid by a government when the imported goods are re-exported or used in the manufacture of exported goods.

[d] A duty remission is an import duty on tax repaid by a government, the refunds being conditional on the firm's meeting domestic production and/or employment requirements.

agreed tariff-reduction schedule, and the changes in tariff classification needed to qualify for tariff-free access to the U.S. market. The rules of origin — the set of measures used to differentiate between goods originating in one country from those in another — determine whether or not a particular good can qualify for tariff-free trade between the two countries. Any goods not satisfying the rules of origin for preferential treatment will be subject to the lowest rate of tariff charged on that good when it is imported from other countries — known as the "most-favored-nation" tariff.

The use of the new Harmonized System will create some confusion for companies engaged in transborder trade. The federal government, through the Department of National Revenue, the Department of External Affairs, and with the assistance of the U.S. Customs Service, needs to assist individuals or companies engaged in Canada-U.S. trade, in order to remove any uncertainties associated with either exporting and importing or in determining the relevant rules of origin for their particular product.

Another, even larger issue relating to bilateral tariffs is that, overall, Canadian tariffs on most imports from third countries are significantly higher than those imposed by the United States. This puts Canadian producers who purchase component parts from third countries at a competitive disadvantage relative to U.S. firms. The federal government will have to identify these higher-tariff goods and, where the difference in tariff levels poses a problem for Canadian producers, Canadian negotiators should offer to cut the tariffs in the multilateral trade negotiations or lower them to the U.S. level unilaterally.

Technical Barriers

The Agreement disallows the use of standards-related measures as disguised trade barriers. These measures — including specification, regulations, standards and rules for certification systems that apply to goods, and processes and production methods — are often used to impede trade, and they create unnecessary costs to exporting when different standards must be met. Wherever possible, and where consistent with other legitimate domestic objectives, both countries have agreed to harmonize their standards and to consult on changes to them. Each country will also recognize the other's accreditation systems for testing facilities, inspection agencies, and certification bodies.

The Agreement makes it clear, however, that standards should be harmonized only if both sides see mutual advantage in doing so. This does not mean Canada is prevented from determining its own standards regarding such things as the environment or the bilingual labeling of goods. Canada need only ensure that any measure or requirement is applied to both domestic and U.S. goods sold in Canada. For example, it can require that all children's pajamas sold in Canada be made of fireproof material, but it must impose this requirement equally on domestically produced and U.S.-manufactured pajamas.

The federal government should re-evaluate all standards-related measures to determine which can and should be made more compatible with U.S. regulations, in order to facilitate and reduce any unnecessary costs of exporting while not compromising any legitimate domestic objective.

Government Procurement

All three levels of government in both countries purchase large quantities of goods and services under government procurement contracts. The Agreement opens the federal procurement of goods to Canada-U.S.competition on all contracts exceeding a threshold level that has been lowered to U.S.$25,000 from U.S.$171,000. The Agreement does not cover procurement of services, nor does it include provincial, state, or local procurement.

Most government departments on both sides of the border are included in these provisions — except for the U.S. Departments of Energy and Transport, and for the Canadian Departments of Transport, Communications, and Fisheries and Oceans. However, the Agreement only gives Canada access to about C$4 billion of U.S. procurement, out of a total U.S. federal, state, and local procurement market of C$700 billion. The Agreement directs both governments to seek to improve and expand the coverage of the federal procurement market shortly after the Uruguay Round has concluded; this should be a high priority at that time.

Services

The Agreement's provisions on trade in services offer a framework for incorporating some of the GATT's general principles on trade in goods into the services sector. The growing volume of bilateral trade in services made their inclusion in the Agreement highly desirable. However, the Agreement's provisions regarding services should be seen only as a beginning. Much more can be done. For example, detailed sectoral annexes, which clarify the general obligations of the services provisions, have been derived so far only for architecture, tourism, and computer and telecommunications network-based services.

The Agreement provides scope for the two countries to extend and negotiate more sectoral annexes in the future. It is in Canada's interest to pursue such negotiations vigorously. In this way, trade in these services can be facilitated, and detailed annexes, by making each country's obligations clearer, can reduce the potential for trade-related disputes.

Trade-Remedy Laws

The Agreement leaves in place — for a five-to-seven-year period once the treaty takes effect — both countries' domestic antidumping and countervailing duty laws. Each country can continue to apply its respective laws, and can change them, subject to certain conditions laid out in the Agreement, until a mutually acceptable set of trade laws is developed. Once established, these laws will replace the unilateral application of domestic antidumping and countervailing duty rules.

Late in 1988, the U.S. Congress passed the *Omnibus Trade and Competitiveness Act*, which had been three years in the making.[16] Many of the United States' trading partners have criticized the Act as being protectionist. Many Canadians have complained that the legislation did not specifically exempt Canada from its terms, thereby contradicting the intent and purpose of the Free Trade Agreement.

Although much can be said about the nature and potential impact of the legislation, one point, particularly relevant for Canada-U.S. trade, is often overlooked. The dispute settlement procedures, rules, and obligations of the GATT and the Free Trade Agreement supersede those contained in the *Omnibus Trade Act* for bilateral trade between Canada and the United States. This means, for example, that the United States can force Japan into accepting a voluntary export restraint agreement for steel, as provided for in the Act, but it cannot impose the same restraint on Canadian steel producers, since such practices are prohibited by the terms of the bilateral treaty.

Some people have been highly critical of the Agreement's dispute settlement mechanisms and the provisions allowing for a five-to-seven-year period to develop new trade-remedy laws. The C.D. Howe Institute does not concur with this criticism. Canada's trade-distorting subsidies remain just as vulnerable — no more, no less — to U.S. retaliation as they were before the Agreement. The Institute believes, however, that the Agreement's dispute settlement procedures go far in constraining the use of U.S. trade laws to attack, for example, generally available, nondistorting subsidies.

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[16] See "White House Fact Sheet on Trade Bill," United States Embassy, Ottawa, August 30, 1988; and "Trade Expert Judy Bello Discusses New U.S. Omnibus Trade Bill," United States Embassy, Ottawa, September 9, 1988.

Negotiations to develop a mutually agreeable code for subsidy and antidumping practices seem to have been politically too sensitive and practically not feasible in the short time during which the Agreement was struck. A long education process will be required on both sides of the border in order to reach a compromise. Americans must learn the extent to which their country provides subsidies, particularly through national defense and state government programs. Canadians must realize how many of their subsidy policies could be eliminated without compromising legitimate national goals. Much research also needs to be undertaken to distinguish between those subsidies that distort trade and those that do not.

Some preliminary observations on the direction and nature of the negotiations can be made. A definition of "subsidy" must be a top priority for the negotiators. One approach to help focus the discussion would be to group the subsidies into categories, such as:

- "actionable subsidies" — those that can be subjected to possible U.S. countervail;
- "prohibited subsidies" — those that are not allowed; and
- "safehaven subsidies" — those that are exempt from any countervailing duties.

The nature of the negotiations should involve a coordinated effort between research institutions, business, government, and other interested groups. Much of this can and will take place through forums such as the International Trade Advisory Committee and the Sector Advisory Groups on International Trade. Both of these groups, set up by the federal government and composed of individuals knowledgeable in trade matters, have been involved in providing consultation to the government during the trade negotiations.

Regardless of the outcome of negotiations in this area, both countries will continue to be able to refer to the GATT's dispute settlement provisions. Anything superior to the status quo contained in the GATT will doubtless be accepted, if mutually beneficial.

In the event, Canada should initiate a research program to help identify mutually agreeable rules on subsidies and antidumping practices. As soon as a Canadian strategy is developed, the government should engage the United States in negotiations on bilateral trade laws, since such talks are likely to be difficult and protracted.

Adjustment Issues

Achievement of the full benefits of free trade with the United States will require rationalization and adjustment on the part of Canadian industry.[17] Just how large the adjustment will be, however, is uncertain. Canadian producers would have had to adjust and adapt to more intense foreign competition, to the rapid globalization of markets, to the increasing pace of technological developments, to movements in exchange rates, and to shifts in relative growth abroad regardless of whether or not there was a free trade deal with the United States. Policy changes such as deregulation, tax reform, and multilateral trade liberalization are also forcing change on Canadian producers.

The Institute's view is that, in Canada, the adjustment will be modest relative to the other changes that are going on in the economy continuously,[18] for several reasons.

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[17] For a discussion, see Ronald J. Wonnacott with Roderick Hill, *Canadian and U.S. Adjustment Policies in a Bilateral Trade Agreement*, CAC 57 (Washington, D.C.; Toronto: Canadian-American Committee, 1987).

[18] See Edward A. Carmichael and Katie Macmillan, *Focus on Follow-through*, Policy Review and Outlook, 1988 (Toronto: C.D. Howe Institute, 1988), pp. 79-82.

- The Canadian economy is continually being bombarded by foreign shocks of greater magnitude than the phased elimination of Canada-U.S. trade barriers over a ten-year period.
- Adjustment costs were small in the EC, EFTA, and the Australia-New Zealand Agreement, where tariff cuts were speeded up rather than slowed down.
- Canada's own experience with trade liberalization in the postwar period suggests that most adjustment will take place within firms and industries, rather than between industrial sectors. Past experience indicates that freer trade is likely to nave a positive impact on Canadian employment.
- The long list of Canadian industries that have agreed to an accelerated phaseout of tariffs is direct testimony that many anticipate no serious adjustment problems.

The federal government has commissioned a blue-ribbon committee, the de Grandpré Commission, to make recommendations on the form and substance of any adjustment assistance. The Commission is due to report its findings and table its recommendations in the spring of 1989. In the meantime, the Institute here offers a brief treatment of what it feels are the important elements of an effective adjustment policy.

The central issue is whether workers who lose their jobs because of free trade should be treated differently than workers who lose their jobs for other reasons. The government's view to date is that all displaced workers should be treated the same and accommodated by the labor market programs now in place.

This approach would hold more appeal if existing labor market programs — namely, Unemployment Insurance and the Canadian Jobs Strategy — were capable of fostering positive adjustment and employment growth. Unfortunately, they are not. The Macdonald Commission, the Forget Commission, and others have pointed to disincentives embodied in the UI system — for example, those that encourage dependence and impede labor mobility.

A major reform of existing programs, along the lines discussed earlier in this chapter, would ensure that all displaced workers, not only that small minority hurt by free trade, could benefit from better-designed adjustment policies.

In the absence of revamped labor market programs, the next best alternative may be to augment inadequate existing programs with targeted assistance to workers whose dislocations are demonstrably related to free trade with the United States. It makes both political and economic sense that some portion of the gains from free trade be allocated to those negatively affected by it.[19] Under this approach, strict criteria would be used to grant any additional adjustment assistance. Such criteria might include:

- that the affected individuals were employed in an industry (or firm) in which trade barriers have been lowered through the Agreement's provisions; and
- that the reduction of these trade barriers is demonstrably the main cause of dislocation.

Any additional assistance should be designed to smooth and speed up the adjustment process and to encourage a more equitable sharing of the benefits of free trade. In other words, the aim of government assistance should be to create a more skilled, mobile, and adaptable labor force. Trade-displaced workers should be encouraged to move between regions, industries, and occupations.

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[19] As two Brookings Institution economists have argued, policymakers should adopt a pragmatic approach of aiding losers from liberalized trade in order to reduce both the demands for permanent protection and the willingness of governments to supply it. See Robert Z. Lawrence and Robert E. Litan, *Saving Free Trade: A Pragmatic Approach* (Washington, D.C.: Brookings Institution, 1986), p. 7.

Adjustment assistance should be directed to individuals and communities, not firms, for three reasons. First, firms have access to capital markets to cover their costs of adjustment, while individuals cannot normally borrow to obtain funds for retraining or relocation. Second, firms have better and more complete information about the nature and availability of alternative opportunities than do individuals. Third, assistance to firms in the form of subsidies, for example, delays the rationalization of industry and inhibits the shift of employment into more competitive sectors of the economy.

Once known, the de Grandpré Commission's recommendations should be evaluated and acted on, or alternatives sought quickly, in order to speed the rationalization of industry in response to free trade and to ease the adjustment costs individuals face.

New Trade Initiatives

Canada now has in place a firmly rooted, two-track policy for pursuing access to foreign markets for Canadian exporters. This does not mean, however, that the Canadian trade policy agenda is now complete. Canada should continue to pursue trade liberalization within multilateral rules, particularly in parts of the world as yet relatively unpenetrated by Canadian producers, such as the Asian Pacific Rim countries.

If Canada is serious about achieving greater trade liberalization with countries on the Pacific Rim, it must be willing to undertake tough negotiations and be prepared to table some concessions. The forum for this is, of course, the GATT. Canadian negotiators can bargain bilaterally or in small groups with countries in this region, to achieve substantial reductions in both tariff and nontariff trade barriers. Because of the fiercely competitive natures of these economies, this is a necessary first step leading gradually to greater liberalization in other aspects of Canada's trade.

Canada has a vital stake in the multilateral trading system, so it is important for the Uruguay Round to succeed in further liberalizing world trade. Thus, Canadian trade policy should continue to focus on the current multilateral trade negotiations.

Over the longer term, however, Canada should investigate the possibilities of further regional trade liberalization within GATT rules. For example, Canada, Australia, and New Zealand have complementary economies and no doubt can gain through liberalized trading rules, perhaps to the extent of a free trade area. This type of arrangement might also involve the United States. Much research needs to be undertaken to assess carefully the possibilities and benefits of such a grouping, but research of this kind can increase these countries' awareness of each other's economies and the opportunities for prosperous exchange.

Structural Policies

Regulatory Reform and Privatization

Among the least noticed but most significant accomplishments of the Conservative government during the 1984–88 period was its program of regulatory reform and privatization. Reform of regulations governing foreign investment, energy, transportation, and financial industries represented a positive response to changes in the global competitive environment. The privatization of some Crown investments that were no longer fulfilling a public policy objective represented a pragmatic approach to public enterprise in Canada.

Although some observers have interpreted these policy initiatives as ideological, closer examination does not support this view. Canada and numerous other countries have moved to reduce regulation not on ideological grounds but because the power of governments to restrict choices of consumers has been eroded by intensifying competition. As Richard Schultz points out, "regulated systems are increasingly porous and penetrated by those who are non-regulated to offer the same or equivalent services...at prices or conditions more attractive than those offered by the regulated firms."[20]

In this view, Canadian air travellers opting for U.S. carriers were responsible for Canadian airline deregulation. U.S. energy consumers switching away from Canadian natural gas were responsible for the deregulation of natural gas prices. And Canadian borrowers going abroad to issue securities led to regulatory changes in the Canadian securities industry.

In a similar fashion, many Crown corporations, realizing that they could be more competitive under private ownership, actively support the government's privatization initiative. This was the case for Air Canada, which faces stiff competition from private carriers.

The lesson to be drawn from recent Canadian experience is not that deregulation and privatization should be pursued in every industry or for every Crown corporation with ideological zeal. Instead, it is that the federal government can manage its regulatory system and its Crown assets with an eye to enhancing competition and efficiency within the Canadian economy and to optimizing the use of taxpayers' assets.

It is this pragmatic approach that should set the tone for regulatory and privatization initiatives in the next agenda. Opportunities do exist for further policy action. These include:

- *completion of phase two of financial regulation reform.* This will involve some difficult choices concerning, first, ownership of financial institutions by nonfinancial organizations and, second, cross-ownership of different financial services within the financial sector. Such choices will involve tradeoffs between objectives such as financial stability, probity, and efficiency. These tradeoffs must be confronted in a world of intense global competition in financial services.

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[20] Richard Schultz, "Regulating Conservatively: The Mulroney Record, 1984–1988," in Andrew B. Gollner and Daniel Salée, eds., *Canada under Mulroney: An End-of-Term Report* (Montreal: Véhicule Press, 1988), p. 202.

- *review of the regulatory system for telecommunications.* The proposed new *Broadcasting Act* will be reintroduced in the next Parliament. Rapidly changing technologies that expand consumer choice and increase competition will drive more broad-based reform of telecommunications regulation.
- *continuation of a pragmatic approach to privatization.* This will involve a plan to complete the privatization of Air Canada and the remainder of the nonrail assets of Canadian National, as well as new initiatives. The new initiatives should focus on companies that no longer fulfill an essential public policy role and/or would be more able to compete effectively if held in private hands. Candidates include the government's 20 percent share of National Sea Products, Radiochemical Co. (a subsidiary of Atomic Energy of Canada Limited), some of the 77 federal airports (which, as a group, lost $600 million in 1986), and some or all of the assets of Petro-Canada. These and other sales of Crown investments, along with the contracting out of services and sales of excess real estate, could reduce net expenditures by $3 billion per year by fiscal year 1992–93.

Science and Technology Policy

The Conservative government gave high priority to defining a new science and technology policy strategy in its first term. The government did not make all the progress hoped for, but it did put in place the building blocks on which future progress can be built.[21]

Based on a consultative process established by the federal government, a new consensus is emerging on the importance of science-based innovation to Canada's future economic growth. There have been efforts to strengthen linkages between industry, government, and university laboratories. Funding of "Centres of Excellence" on university campuses and of science and technology scholarships has increased. Tax incentives for research and development have been enhanced.

Yet, there are continuing reasons for concern about the strength of Canada's scientific and technological base. Canadian industry continues to fund and conduct R&D at low levels. Moreover, Canada's industrial R&D is concentrated in a small number of companies — just 100 companies carry out three-quarters of Canadian industrial R&D, with ten companies accounting for almost 40 percent of the total. This means that the vast majority of Canadian businesses have chosen not to perform their own R&D, which raises questions about their ability to keep up with state-of-the-art technologies. According to the Canadian Institute for Advanced Research,

> Canada's...capacity to perform in industry strategic applied research...is appallingly weak....A strong capacity to perform long-term applied research is essential as part of our industrial structure if strategic market opportunities are to be identified by industry and pursued through sound programs of investments keyed to all the elements in the chain of innovation.[22]

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[21] Rt.Hon. Brian Mulroney, "Notes for an Address at the Opening of the National Conference on Technology and Innovation," Toronto, January 13, 1988.

[22] Canadian Institute for Advanced Research, *Innovation and Canada's Prosperity: The Transforming Power of Science, Engineering and Technology* (Toronto, 1988), p. 45.

Thus, a continuing effort to develop and implement a market-driven national science and technology strategy should be a priority of the federal government's next agenda. Throwing money at science and technology is not the answer. Canada already has a generous system of R&D support relative to other industrial countries. While the relatively low level of industry spending on R&D is of concern, it is the market success of the research rather than how much industry spends that is important. In part, Canada's low spending level results from its comparative advantage in non-R&D-intensive industries. In part, it results from the significant role of foreign-owned multinationals in Canada, much of whose R&D function is performed in the home country. But in many industries, Canadian firms simply invest less in R&D than do their counterparts in other industrial countries.

In the future, the consequences of this neglect of R&D and innovation will become more serious. Trade liberalization, both bilateral and multilateral, will erode the sheltered position of some Canadian industries. The rapid pace of technological change, not only in the United States and Japan but also in the newly industrializing countries, will heighten the need for Canadian business to become more technologically competitive. It is these market realities that will have the greatest impact on industrial R&D in the years ahead.

The federal government's task, then, is to continue to provide strong encouragement and a favorable climate for science and technology. Efforts should focus on:

- developing a broad consensus on the need to improve Canada's scientific and technological base and to identify and capitalize on strategic market opportunities;
- promoting industrial consortia, particularly to augment Canada's capacity for long-term, applied research;
- promoting linkages between industry, university, and government research to train specialists and to aid technol-

ogy transfer — in some cases, the latter could involve privatizing government-funded research;

- expanding the availability of private equity capital to finance smaller, technology-based companies; and
- improving the administration of tax incentives for R&D and innovation. Currently, for example, it is more difficult for individuals or small businesses than for large corporations to take advantage of the refundable credit. In part, this is because there is an average lag of 24 months before a firm receives the refundable R&D tax credit to which it is entitled. Such a long lag diminishes the benefit of this incentive, particularly for smaller, entrepreneurial companies.[23]

Government can help to focus a national science and technology strategy and create a climate conducive to innovation. Ultimately, however, Canada's success in this area will depend not on new government subsidies but on efforts and results in the private sector.

Agriculture

Canadian agricultural policy during the 1984–88 period was motivated primarily by a desire to maintain farm incomes in the face of depressed prices and intense international competition. Price and supply conditions in global markets show little sign of improvement in the short term, suggesting that the demand for government assistance will continue.

While most Canadians did not object to farm support in a time of hardship, they could very well resist the continuation of subsidies at the level of the past two years. The prospect of an indefinite continuation of ruinous global subsidies should provoke an examination of Canadian farm policy with a view to developing strategies to adjust to market realities.

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[23] Canadian Chamber of Commerce, *Focus 2000: Report of the Task Force on Making Investment Capital Available* (Toronto, 1988), p. 43.

Canada might receive some assistance in this regard from the multilateral trade negotiations. Progress in the Uruguay Round, if forthcoming, may dictate changes to Canadian agricultural policy in the future. While aggregate support to Canadian farmers during the 1984–86 period was in the middle range for OECD countries, as shown in Table 17, support to dairy and grain farmers was particularly high. Table 18 shows the impact of Canadian agricultural programs on production, consumption, trade, and prices. Because of their positive effect on trading volumes, the Special Canadian Grains Program (SCGP) and grain freight rate subsidies provided under the *Western Grain Transportation Act* (WGTA) are likely to attract the attention of foreign negotiators.

Negotiators at the Uruguay Round view the gradual replacement of existing trade-distorting measures with direct income support to farmers as a key element in the liberalization of agricultural trade. This type of assistance, which is referred to as "decoupled" farm support, would have much less impact on production, trade, and resource allocation than do existing farm programs.[24] Instead of basing support on acreage seeded, volume of production, or inputs employed, decoupled support would maintain farmer incomes in time of hardship through income-insurance payments or direct income-deficiency payments.

Some have argued that Canada ought not to replace current trade-distorting measures such as the SCGP and WGTA in anticipation of being asked to do so in the Uruguay Round if it could use subsidy reductions to obtain concessions from trading partners. This ignores the possibility, however, that the GATT might not succeed in reducing agricultural subsidies. It also disregards the many advantages that decoupled farm support has over existing policies, chief among these being that it promotes flexibility and market responsiveness.

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[24] For a discussion of decoupling and its application to agricultural trade reform, see Gilson, *The GATT Midterm Review and Agriculture.*

Table 17
Producer Subsidy Equivalents by Commodity and Country, 1984–86
(as a percentage of producer income)

Commodity	Canada	European Community[a]	Japan	United States	Average[b]
Wheat	41.1	36.3	97.7	44.3	40.5
Coarse grains	42.1	26.4	98.1	30.0	30.1
Rice	n.c.	68.0	85.9	61.0	84.4
Soybeans	n.c.	58.5	84.0	10.1	13.0
Other oilseeds	29.5	35.7	n.c.	n.c.	33.6
Sugar (refined equivalent)	36.8	74.7	71.8	76.0	70.8
Milk	96.7	55.8	81.8	66.3	63.0
Beef and veal	15.6	53.0	55.4	9.4	30.4
Pigmeat	5.0	6.2	40.1	6.4	10.6
Poultry	17.4	26.9	15.9	9.9	16.2
Sheepmeat	n.c.	63.0	n.c.	7.8	52.6
Wool	n.c.	n.c.	n.c.	68.5	12.1
Eggs	4.7	17.8	19.0	7.2	14.2
Crops	39.7	40.9	46.2	25.9	34.8
All products	39.2	40.0	68.9	28.2	38.4

n.c. = not calculated.

[a] Excluding Portugal and Spain.

[b] Weighted average of the following: Australia, Austria, Canada, the European Community (except Portugal and Spain), Japan, and the United States.

Source: Organisation for Economic Co-operation and Development, *Monitoring and Outlook of Agricultural Policies, Markets and Trade* (Paris, May 1988).

The government should make it a priority in its new term to replace the SCGP with some form of income stabilization plan that is consistent with international objectives for trade reform. Such a plan should not discriminate between regions or products. It should also provide a support level that helps in times of hardship but that is not so generous as to constitute ongoing income support during normal market conditions.

Various options for decoupled income assistance exist. One is the Net Farm Income Insurance plan proposed by Professors Finkle and Furtan of the University of Saskatchewan. Another is the Economic Council of Canada's proposal for a four-component income-insurance and stabilization scheme,

Table 18
Effects of Canadian Agricultural Programs on Production, Consumption, Trade, and Prices

Program	Effect on[a]					
	Production	Consumption	Trade	Domestic Price	World Price	Resource Allocation
Bilateral trade agreement	no	no	no	no	no	no
Farm Credit Corporation	no	no	no	no	no	small
Crop insurance	no	no	no	no	no	small
Agricultural Stabilization Act	small (+)	no	small (+)	small (-)	n.s.	small
Western Grains Stabilization Act	small (+)	no	small (+)	no	n.s.	small
Western Grain Transportation Act	small (+)	no	yes (+)	no	n.s.	small
Industrial milk subsidy	yes (-)	yes (-)	yes (-)	yes (+)	n.s.	yes
Supply management	yes (-)	yes (-)	yes (-)	yes (+)	n.s.	yes
Livestock stabilization	yes (+)	no	small (+)	yes (+)	n.s.	yes
Two-price wheat	yes (+)	no	small (+)	yes (+)	n.s.	yes
Special Canadian Grains Program	yes (+)	no	yes (+)	no	n.s.	yes

n.s. = not significant. Because of the small-country assumption, trade effects are not expected to have a significant effect on the world price.

[a] A (+) or a (-) indicates the probable direction of influence.

Source: Barry Carr et al., "A North American Perspective on Decoupling," in William M. Miner and Dale E. Hathaway, eds., *World Agricultural Trade: Building a Consensus* (Halifax, N.S.: Institute for Research on Public Policy and Institute for International Economics, 1988), p. 125.

which would see governments and producers contribute to programs to provide assistance when farm incomes fall.[25]

A decoupled income-support plan will promote diversification and flexibility in agriculture. This is not enough, however. Programs to assist those who decide to leave farming, to promote soil conservation practices, and to increase research and development activities are important if the farm sector is to maintain its efficiency in the longer term.

Trade policy will remain an important component of farm policy. Canada's commitment to agricultural trade reform at the multilateral level undoubtedly will continue throughout this government's term and beyond. The best hope for making a meaningful contribution to the process rests with pursuing trade reform through the Cairns Group and, to a lesser extent, with the United States.

If the GATT negotiations succeed, Canada will be required to make concessions, in the form of reductions in farm-support levels, in return for subsidy reductions by foreign competitors. Some difficult tradeoffs between regions and commodity groups also might be necessary. Cuts in foreign grain subsidies, for example, might be contingent on Canada's easing import quotas in the dairy, egg, and poultry industries. While decisions on which farm sectors are to be affected by subsidy cuts will be contentious, reductions in farm-support programs through the GATT offer major benefits to Canada. Such benefits include the opportunity to improve exports, productivity, and farm incomes while reducing government's presence in agriculture.

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[25] Peter Finkle and W. Hartley Furtan, "Net Farm Income Insurance" (Paper presented to the Symposium on Decoupling sponsored by the Canadian Institute of Resources Law and Agriculture Canada, Ottawa, February 11–12, 1988); and Economic Council of Canada, *Handling the Risks: A Report on the Prairie Grain Economy* (Ottawa: Supply and Services Canada, 1988).

Economic Policy and the Environment

Although the environment was not on the government's agenda in 1984, it should be in 1989. During the past four years, environmental concerns have increased around the world. Worrisome environmental deterioration — ozone depletion, toxic waste, atmospheric warming — have forced people in all countries to confront the evidence that human economic activity is affecting the physical environment.

Canada is no exception in facing a new challenge spelled out by the Brundtland Commission: to devise strategies for "sustainable development" — economic growth that preserves the environment for future generations.[26] This concept commands almost universal consent because it appears to be the only viable long-term strategy. No country, however, has yet made it operational.

Contrary to the general impression that the environment has been ignored over the past four years, the reality is that a great deal of environmental protection regulation has been implemented and a great deal of industry, government, and university consultation has taken place.[27] In particular, federal-provincial agreements have mandated a 50 percent reduction in acid-rain-causing sulphur-dioxide emissions by 1994; allowable emissions of nitrogen oxide from motor vehicles have been cut by 60 percent, giving Canada the toughest standards in the world; lead in gasoline will be outlawed by the end of 1992; and the *Canadian Environmental Protection Act*, passed in 1988, provides national standards to regulate the use of toxic chemicals and contains tough sanctions and fines against industrial polluters.

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[26] World Commission on Environment and Development, *Our Common Future: Report to the United Nations General Assembly* (Oxford: Oxford University Press, April 1987). See also Jim MacNeill, "Sustainable Growth", *Policy Options*, March 1988, pp. 22–25.

[27] See comments by Environment Minister Thomas McMillan on the Conservative government's environmental record in House of Commons, *Debates*, 2nd session, 33rd Parliament, March 21, 1988, pp. 13939–13943.

While much has been done, the results seem meager in relation to the perceived environmental threats. The toxic waste accident at St-Basile-le-Grand, Quebec in the autumn of 1988 demonstrated that much of the recent activity will take years to bear fruit. In the meantime,the neglect of the past needs remedying.

Canada has been a world leader in participating in and responding to the Brundtland Commission. The National Task Force on Environment and Economy — a committee composed of seven environment ministers, seven representatives of major industries, two representatives of environmental groups, and one academic — submitted its report to the Canadian Council of Resource and Environment Ministers in September 1987.[28] This blue-ribbon panel unanimously endorsed a broad set of recommendations calling for governments to change the way they approach the environment and the economy and to make environmental considerations "integral to economic policy making and planning and a required element of any economic development proposal."[29] The report also calls on industry to show leadership by adopting codes of practice that enshrine its responsibility to conserve resources and protect the environment. The Task Force's report is viewed internationally as a model of how countries should respond to the challenge of sustainable development.

Thus, Canada has begun to confront its environmental challenges within a global context. In spite of the leadership of a few Canadians, however, a national consensus does not yet exist on the need for tougher environmental laws or on who will pay for environmental cleanup and protection.

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[28] National Task Force on Environment and Economy, *Report* (Downsview, Ont.: Canadian Council of Resource and Environment Ministers, 1987). For a review of the Report, see Alistair Crerar, "Brundtland Bettered," *Policy Options*, November 1987, pp. 28–30.

[29] National Task Force on Environment and Economy, *Report*, p. 6.

In shaping that consensus, it is important not to lose sight of the fact that concern for the environment can complement a market-oriented economic framework. Indeed, markets working within an appropriate set of environmental guidelines may well be the best mechanism for ensuring sustainable development. Markets can supply a clean environment if governments set the appropriate rules.

Governments have many options for how they set environmental rules.[30] They can regulate, setting strict limits on environmentally damaging emissions, as Canada has done on sulphur dioxide. They can impose taxes on polluters, such as effluent charges levied by some countries on companies that discharge waste into rivers. Or they can auction rights to companies to emit specified levels of pollution, as is done in some industries in the United States.

Regulation is the bluntest instrument of these three, with potentially the most negative effect on economic growth for a given level of environmental protection. In some cases, strict regulations will be required because the cost of repairing certain types of environmental damage is extremely high. In other cases, however, where the objective is to reduce allowable emissions, some combination of pollution taxes and permits can provide the desired amount of environmental protection at the lowest cost in terms of foregone economic growth. The reason is that these devices create incentives for industry to introduce nonpolluting technologies.

Most important is for governments to work with the private sector in tackling Canada's environmental challenges. Governments can encourage firms to install environmentally sound technologies when new plants are build, thereby reducing the need for more costly remedial actions later. In this way, the creativity of markets can be harnessed to protect and improve the environment.

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[30] This discussion draws on "Politicians Change Colour," *The Economist*, October 15, 1988, pp. 15–16.

Conclusions and Recommendations

The outcome of the November 1988 election was a signal for the federal government to continue with the new direction in economic policy it had established in 1984. Economic performance improved in Canada during the government's first term, but this should not be allowed to breed complacency among Canadians. Much remains to be done to reduce the vulnerability created by Canada's large public debt and to enhance Canada's competitiveness, living standards, and quality of life.

The government's second mandate gives it an opportunity to make additional progress in its two-pronged strategy of restoring better fiscal balance within government and removing obstacles to economic growth in the private sector. To succeed, however, the government will have to do a better job than it did in its first four years of convincing Canadians of the benefits of this strategy. It will also, in the Institute's view, have to give higher priority to improving social policies and preserving the environment.

In this final section, the Institute presents its policy recommendations for the next agenda.

Fiscal and Monetary Policies

- The federal government should cut the budget deficit in half over the next four years through reductions averaging $4 billion per year. This would be sufficient to stabilize the debt-to-GDP ratio by fiscal year 1990–91 and begin to reduce it thereafter. The necessary deficit reduction should be accomplished through a combination of continued expenditure restraint along with a program of privatization and, if necessary, tax increases.

- The Bank of Canada should continue to take steps, as needed, to head off inflationary pressures before they become entrenched. At the same time, the Bank could accomplish its task by relying less on higher interest rates if deficit reduction played a greater role in containing the growth of demand.

Tax and Social Policies

- The federal government should bring forward at the earliest possible date a concrete proposal for replacement of the federal manufacturers' sales tax with a National Sales Tax. The proposal should ensure that the refundable sales tax credit is increased to offset fully any negative impact of the reform on low-income Canadians.

- In the process of sales tax reform, the federal government should work with the provinces to reduce the poverty traps created by high implicit tax rates facing Canadians who move from government social assistance to work. Eliminating unnecessary obstacles facing these individuals could do more than any other policy measure to reduce unemployment.

- In reforming the sales tax, the federal government should also take the opportunity to re-examine the investment income provisions of Stage I reforms and to lower the personal income tax rate for middle-income taxpayers.

- The federal government should undertake to reform Canada's system of social programs to ensure that they provide adequate and sustainable assistance to low-income Canadians without creating poverty traps that encourage dependence. This will involve improving the integration of personal taxes and transfers to reduce implicit tax rates on low-income workers and improving the targeting of elderly benefits to low-income seniors.

Trade Policy

- In 1989–90, Canada should focus its attention on achieving its objectives in the Uruguay Round of multilateral trade negotiations. In particular, Canada should work with like-minded countries to liberalize trade in agriculture and to make progress in other areas important to Canada, including government procurement, dispute settlement, services, and tariff reduction.

- In order to ease the adjustments faced by individuals and to speed the rationalization of industry in response to free trade with the United States, the recommendations of the de Grandpré Commission on adjustment assistance, once known, should be evaluated and acted on, or alternatives sought quickly. The federal government should use the opportunity presented by the de Grandpré Commission's recommendations to reopen the debate on restructuring unemployment insurance, with a focus on encouraging adjustment and providing training and other assistance to those genuinely unable to find work.

- The federal government should move quickly to deal with unresolved issues in implementing the Canada-U.S. Free Trade Agreement. The Department of National Revenue and the Department of External Affairs should provide information and expert assistance to remove uncertainties relating to rules of origin and tariff rates on Canada-U.S. trade. The government should also re-evaluate Canadian and U.S. standards to ensure that they do not constitute disguised trade barriers.

- The federal government should press for continuing negotiations to improve Canadian access to the U.S. market, particularly in the areas of government procurement and covered services. In the latter case, the government should work with the United States to add more sectoral annexes to the services chapter of the Agreement.

- The federal government should move quickly to sponsor a research, education, and consultation process to establish an acceptable definition of subsidies to govern bilateral trade. Once a negotiating strategy is developed, the government should engage the United States in negotiations on countervailing and antidumping duties.

- The federal government should participate actively in sponsoring research and building a consensus for liberalizing trade among the Pacific Rim countries, while ensuring that this does not in any way undermine multilateralism.

- Canada should continue to press, independently and through the Cairns Group, for the reduction of trade-distorting agricultural subsidies in the Uruguay Round. In the process, Canada, like other countries, will be required to reduce its own trade-distorting agricultural subsidies. In reforming domestic agricultural policies, Canadian governments should give priority to policies that provide temporary support for farm incomes while encouraging adjustment to changing realities in global agricultural markets.

Structural Policies

- The federal government should accord high priority to completing the reform of financial regulation that it began in its first term.

- The federal government should continue and accelerate its pragmatic approach to privatization, focusing on Crown assets or services that no longer fulfill an essential public policy objective.

- The federal government should continue its efforts to develop and implement a market-oriented national science and technology strategy that leads to the rapid diffusion of new technology and that is driven by Canadian industry's efforts to identify and capitalize on strategic market opportunities.

- Canadian governments should work with the private sector to improve Canada's system of education and training to enable Canadians to participate more fully in the benefits that economic change associated with freer trade, changing technologies, and increasing global competition will bring.

- Canadian governments should work with the private sector and with other countries to devise strategies for sustainable development — economic growth that preserves the environment for future generations. In devising such a strategy, they should harness the creativity of the private sector in finding solutions to the environmental concerns facing Canada and the world.

These recommendations cover a wide range of interrelated government policies. In the Institute's view, the federal government should articulate in 1989 a comprehensive policy agenda, as it did in 1984. In its next agenda, the government should take advantage of the lessons of its first term by dealing soon with issues, such as the deficit and tax reform, on which professional consensus already exists and by building consensus in other areas, such as social policy reform and the environment, on which there is less agreement as to the best approach. The focus should be on creating a dynamic, competitive, and outward-looking Canada. Only an adaptable, internationally oriented economy can provide the growth in living standards on which Canadians' economic well-being, social programs, and environmental protection ultimately rest.

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